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17 CFR Parts 240 and 249
Broker-Dealer Reports; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249

[Release No. 34–64676; File No. S7–23–11]

RIN 3235–AK56

Broker-Dealer Reports

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (the ''Commission'') is proposing amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934 (the ''Exchange Act''). The first set of amendments would, among other things, update the existing requirements of Exchange Act Rule 17a–5, facilitate the ability of the Public Company Accounting Oversight Board (the ''PCAOB'') to implement oversight of independent public accountants of broker-dealers as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act''), and eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers. The second set of amendments would require broker-dealers that either clear transactions or carry customer accounts to consent to allowing the Commission and designated examining authorities (''DEAs'') to have access to independent public accountants to discuss their findings with respect to annual audits of the broker-dealers and to review related audit documentation. The third set of amendments would enhance the ability of the Commission and examiners of a DEA to oversee broker-dealers' custody practices by requiring broker-dealers to file a new Form Custody.

DATES: Comments should be received on or before August 26, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–23–11 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–23–11. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551–5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551–5521; Randall W. Roy, Assistant Director, at (202) 551–5522; and Mark M. Attar, Branch Chief, at (202) 551–5889, Division of Trading and Markets; or John F. Offenbacher, Senior Associate Chief Accountant, at (202) 551–5300, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–7010.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to Exchange Act Rule 17a–5 and proposed Form Custody.

I. Introduction

The Commission is proposing three sets of amendments to Exchange Act Rule 17a–5—the broker-dealer financial reporting rule.[1] The first set of amendments (collectively, the ''Annual Reporting Amendments'') relates to the requirement that a broker-dealer file annual financial reports with the Commission. The Annual Reporting Amendments are designed to, among other things: (1) Update the existing requirements of Rule 17a–5; (2) facilitate the ability of the PCAOB to implement oversight of independent public accountants of broker-dealers as required by the Dodd-Frank Act;[2] and (3) eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers.

The second set of amendments (collectively, the ''Access to Audit Documentation Amendments'') would require broker-dealers that either clear transactions or carry customer accounts to consent to provide the Commission and DEAs with access to independent public accountants to discuss their findings with respect to annual audits of broker-dealers and to review related audit documentation.[3]

The third set of amendments (collectively, the ''Form Custody Amendments'') would enhance the ability of the Commission and examiners of a DEA to oversee broker-dealers' custody practices by requiring broker-dealers to file on a quarterly basis a new Form Custody. Form Custody would elicit information as to whether and how a broker-dealer maintains custody of cash and securities of customers and others.

II. The Proposed Annual Reporting Amendments

A. Background

Sections 17(a) and (e) of the Exchange Act and Rule 17a–5 together require a broker-dealer to, among other things, file an annual report (an ''Annual Audit Report'') containing audited financial statements, supporting schedules, and supplemental reports, as applicable, with the Commission and the broker-dealer's DEA.[4] The financial statements must be comprised of a statement of financial condition, a statement of income, a statement of cash flows, a statement of changes in stockholders' or partners' or sole proprietor's equity, and a statement of changes in liabilities subordinated to claims of general creditors.[5] The supporting schedules must be comprised of a computation of required and actual net capital under

[1] 17 CFR 240.17a–5 (''Rule 17a–5'').

[2] Public Law 111–203 (Jul. 21, 2010).

[3] PCAOB Auditing Standard 3 defines ''Audit documentation'' as the ''written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as *work papers* or *working papers.''*

[4] *See* 15 U.S.C 78q(a), 15 U.S.C 78q(e), and Rule 17a–5(d).

[5] *See* Rule 17a–5(d)(2).

Exchange Act Rule 15c3–1, and, for broker-dealers that maintain custody of customer funds or securities (''carrying broker-dealers''), a computation of the customer reserve requirement and information relating to the possession or control requirements under Exchange Act Rule 15c3–3.[6] The supplemental reports include: (1) A report of an independent public accountant that is the result of a review of, among other things, the broker-dealer's accounting system, internal accounting control and procedures for safeguarding securities, and practices and procedures in complying with various Commission financial responsibility rules and Regulation T of the Board of Governors of the Federal Reserve System;[7] (2) a report of an independent public accountant provided to, among others, the Securities Investor Protection Corporation (''SIPC'') to help administer the collection of assessments from broker-dealers for purposes of establishing and maintaining its broker-dealer liquidation fund (the ''SIPC Fund'');[8] and (3) for broker-dealers that compute net capital under an alternative model-based standard, a report of an independent public accountant indicating the results of the accountant's review of the internal risk management control system established and documented by the broker-dealer in accordance with Exchange Act Rule 15c3–4.[9]

Paragraph (g) of Rule 17a–5, entitled ''Audit objectives,'' describes the objectives that should be achieved by an independent public accountant in preparing a report for the broker-dealer to file with its Annual Audit Report.[10] For example, the audit is required to be performed in accordance with generally accepted auditing standards (''GAAS'').[11] In addition, paragraph (g)(1) of Rule 17a–5 requires that the audit include a ''review'' and appropriate tests of the broker-dealer's accounting system, internal accounting control and procedures for safeguarding securities for the period since the prior examination date.[12] The paragraph further states that the scope of the audit and review of the accounting system, internal accounting control, and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing in those items, including in the procedures for obtaining and maintaining physical possession and control of all fully paid and excess margin securities, complying with Regulation T, and making the quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by Exchange Act Rule 17a–13 would be disclosed.[13] Currently, with respect to these requirements, independent public accountants for broker-dealers issue a report describing a ''study'' of these practices and procedures and, if applicable, notification to the Commission of the discovery of any material inadequacies (the ''Study''). The form of the report that describes the Study is specified in an AICPA publication entitled *AICPA Audit & Accounting Guide: Brokers and Dealers in Securities;*[14] however, the form of the report does not specify the level of assurance required to be obtained by the independent public accountant when performing the Study.

Professional auditing standards provide for three levels of attestation engagement by an accountant.[15] Under the highest level of attestation engagement, the accountant obtains ''reasonable assurance'' with respect to the matter that is the subject of the accountant's attestation engagement and provides an opinion. This standard is required with respect to audits and examinations.[16] The second level of attestation engagement is a review, which results in the accountant obtaining a moderate level of assurance with respect to the matter that is the subject of the accountant's attestation engagement. The third type of attestation engagement is one in which the accountant performs agreed-upon procedures, which results in no assurance, but rather a reporting of the accountant's findings after the performance of procedures that have been agreed to by specified parties. Rule 17a–5 currently requires that a broker-dealer engage an independent public accountant to audit the broker-dealer's financial statements. Some of the supporting schedules are also subject to financial statement audit procedures.

Rule 17a–5 also requires that a broker-dealer that is claiming an exemption from the requirements of Rule 15c3–3 file a report with the Commission.[17] Rule 15c3–3(k) sets forth certain conditions that a broker-dealer must meet to be exempt from the rule's requirements. Generally, the broker-dealer would be exempt if it does not hold customer funds or securities, or, if it does, it promptly forwards all funds and securities received. Rule 17a–5 provides that the independent public accountant engaged by the broker-dealer must ''ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the independent public accountant's last examination.''[18] This requirement has resulted in independent public accountants providing a statement concerning whether they have ascertained that the broker-dealer was complying with the conditions of the exemption.[19]

Many of the requirements currently contained in Rule 17a–5 have existed since 1975, and, for the most part, have remained substantially unchanged.[20] For example, as noted above, to comply with the requirement of paragraph (g) of Rule 17a–5 to conduct an audit and review of the identified matters, independent public accountants currently issue a report based on a Study. The practice of conducting the Study is relatively unique to broker-dealer audits and, while audit literature at one time referred to the performance of a ''study,'' the performance of a study is no longer included in contemporary audit standards governing the work to be performed by an independent public accountant.

[6] *See* Rule 17a–5(d)(3). *See also* 17 CFR 240.15c3–1 (''Rule 15c3–1'') and 17 CFR 240.15c3–3 (''Rule 15c3–3'').

[7] *See* Rule 17a–5(g). *See also* 12 CFR part 220 *et seq.* (''Regulation T'').

[8] *See* Rule 17a–5(e)(4). These reports will be collectively referred to in this release as the ''SIPC Reports.'' As part of the Annual Reporting Amendments, the Commission is proposing to amend how the SIPC Reports are filed; *see infra* Section II.C.

[9] *See* Rule 17a–5(k); *see also* 17 CFR 240.15c3–4.

[10] *See* Rule 17a–5(g).

[11] Auditing and attestation standards for broker-dealers are currently established by the American Institute of Certified Public Accountants (the ''AICPA'').

[12] *See* Rule 17a–5(g)(1).

[13] *Id. See also* 17 CFR 240.17a–13 (''Rule 17a–13''). The term ''material inadequacy'' is defined in Rule 17a–5(g)(3).

[14] *See* the *AICPA Audit & Accounting Guide: Brokers and Dealers in Securities* (Jul. 2010) (the ''Broker-Dealer Audit Guide'').

[15] Professional auditing standards include both GAAS and standards promulgated by the PCAOB.

[16] This proposing release generally refers to an ''audit'' of a broker-dealer's financial statements and an ''examination'' of the broker-dealer's compliance with a particular rule or implementation of controls designed to achieve compliance with a particular rule.

[17] *See* Rule 17a–5(g)(2).

[18] *Id.*

[19] *See* Broker-Dealer Audit Guide, *supra* note 14 at Section 3.32.

[20] *See Broker-Dealer Reports,* Exchange Act Release No. 11935 (Dec. 17, 1975), 40 FR 59706 (Dec. 30, 1975). In this release, the Commission adopted amendments to Rule 17a–5, which included, among other things, the adoption of the requirement for broker-dealers to file Financial and Operational Combined Uniform Single (or ''FOCUS'') Reports.

In addition, recent legislation and Commission rulemaking have further prompted the need to reexamine the requirements pertaining to the Annual Audit Report. First, Section 982 of the Dodd-Frank Act amended the Sarbanes-Oxley Act of 2002 (the ''Sarbanes-Oxley Act'')[21] to provide the PCAOB with explicit authority to, among other things, establish, subject to Commission approval, auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms with respect to the preparation and issuance of audit reports to be included in broker-dealer filings with the Commission.[22] The Dodd-Frank Act also authorizes the PCAOB to inspect registered public accounting firms that provide audit reports for broker-dealers and to enforce standards relative to their audits.

Further, in December 2009, the Commission amended Rule 206(4)–2 (the ''IA Custody Rule'') under the Investment Advisers Act of 1940 (the ''Advisers Act''),[23] which governs investment advisers' custody practices.[24] Among other requirements, registered investment advisers that have custody of client funds or securities must maintain those assets at a qualified custodian, such as a bank or broker-dealer.[25] If an investment adviser that also is, for example, a bank, or its related person, serves as a qualified custodian for advisory client funds or securities, the adviser must annually obtain, or receive from its related person, a written internal control report prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. Broker-dealers that also are registered as investment advisers may, acting in their capacity as broker-dealers, maintain client funds and securities as qualified custodians in connection with advisory services provided to clients, and under the IA Custody Rule are required to obtain internal control reports. Broker-dealers acting as qualified custodians also may maintain advisory assets in connection with advisory services provided by related or affiliated investment advisers. In such instances, these broker-dealers are also required to provide internal control reports to their related investment advisers.

For the reasons discussed above, the Commission is proposing amendments to Rule 17a–5. The amendments proposed by the Commission are intended to update the broker-dealer audit requirements and provide for an examination of compliance, and internal control over compliance, with key regulatory requirements that would provide the Commission with greater assurance as to a broker-dealer's compliance with the requirements. In addition, the proposed changes are intended to facilitate the ability of the PCAOB to set standards for, and implement its inspection authority over, broker-dealers' independent public accountants by providing an improved foundation for the PCAOB to establish new broker-dealer audit standards. Moreover, the proposed changes, as they pertain to compliance with requirements concerning the custody of customer funds and securities, are intended to complement and reinforce the regulatory changes effected by the IA Custody Rule. In particular, the Commission preliminarily believes that broker-dealers that also are registered as investment advisers and hold advisory client funds or securities, or that hold funds or securities for related investment advisers, would be able to use the Examination Report described below to satisfy the internal control report requirements under both Rule 17a–5, as it is proposed to be amended, and the IA Custody Rule.

As discussed below, the proposed changes would provide, as to broker-dealers subject to the requirements of Rule 15c3–3, for an examination of compliance, and internal control over compliance, with respect to Rule 15c3–1, Rule 15c3–3, Rule 17a–5, and rules prescribed by DEAs requiring broker-dealers to send account statements to customers (''Account Statement Rules''). Rule 15c3–1 requires broker-dealers to maintain at all times a minimum amount of net liquid assets, or ''net capital.'' Under Rule 15c3–1, broker-dealers must perform two calculations: (1) A computation of required minimum net capital;[26] and (2) a computation of actual net capital.[27]

Rule 15c3–3 imposes two key requirements on carrying broker-dealers. First, each carrying broker-dealer must obtain physical possession or control over customers' fully paid and excess margin securities.[28] ''Control'' means the broker-dealer must hold these securities free of lien in one of several locations specified in the rule (*e.g.,* a bank or clearing agency).[29] Under Rule 15c3–3, the broker-dealer must make a daily determination from its books and records (as of the preceding day) of the quantity of fully paid and excess margin securities in its possession or control and the quantity of fully paid and excess margin securities not in its possession or control.[30] If the amount in the broker-dealer's possession and control is less than the amount indicated as being held for customers on the broker-dealer's books and records, the broker-dealer generally must initiate steps to retrieve customer securities from non-control locations or otherwise obtain possession of them or place them in control locations.[31]

The second key requirement in Rule 15c3–3 is that the carrying broker-dealer must maintain at a bank or banks cash or qualified securities[32] on deposit in a ''Special Reserve Bank Account for the Exclusive Benefit of Customers'' equaling at least the net amount computed by adding customer credit

[21] 17 U.S.C. 7202 *et seq.*

[22] *See* Section 982 of the Dodd-Frank Act.

[23] 17 CFR 275.206(4)–2 (''Rule 206(4)–2'').

[24] *See Custody of Funds or Securities by Investment Advisers,* Advisers Act Release No. 2876 (May 20, 2009), 74 FR 25354 (May 27, 2009) (''IA Custody Proposing Release''); Advisers Act Release No. 2968 (Dec. 30, 2009), 75 FR 1456 (Jan. 11, 2010) (''IA Custody Adopting Release'').

[25] *See* Rule 206(4)–2.

[26] A broker-dealer's required minimum net capital is the greater of a fixed-dollar amount prescribed in Rule 15c3–1, or an amount computed using one of two financial ratios. The first financial ratio generally provides that a broker-dealer shall not permit its aggregate indebtedness to exceed 1500% of its net capital. *See* Rule 15c3–1(a)(1)(i). The second financial ratio provides that a broker-dealer shall not permit its net capital to be less than 2% of aggregate customer debit items. *See* Rule 15c3–1(a)(1)(ii). Customer debit items—computed pursuant to Exhibit A to Rule 15c3–3, which is described below—consist of, among other things, margin loans to customers and securities borrowed to effectuate customer deliveries of securities on short sales.

[27] A broker-dealer computes its actual net capital by first calculating its net worth using United States (''U.S.'') generally accepted accounting principles. Second, qualifying subordinated loans are added to net worth. Third, illiquid assets such as real estate, fixtures, furniture, goodwill, and most unsecured receivables are subtracted from net worth. Illiquid securities also must be deducted. Finally, the broker-dealer must reduce (''haircut'') the market value of the liquid securities it owns by a percentage amount. This ''haircut'' provides a cushion against adverse market movements and other risks faced by the broker-dealer.

[28] *See* Rule 15c3–3(b)(1).

[29] *See* Rule 15c3–3(c).

[30] *See* Rule 15c3–3(d).

[31] *Id.*

[32] The term ''qualified security'' is defined in Rule 15c3–3 to include securities issued by the U.S. or guaranteed by the U.S. with respect to principal and interest. *See* Rule 15c3–3(a)(6).

items (*e.g.,* cash in securities accounts) and subtracting from that amount customer debit items (*e.g.,* margin loans).[33] Rule 15c3–3 is designed to protect customer funds and securities by generally segregating them from the broker-dealer's proprietary business activities. If the carrying broker-dealer fails, customer funds and securities should be readily available for return to customers. The rule requires carrying broker-dealers to compute the customer reserve requirement on a weekly basis, except where customer credit balances do not exceed $1 million (in which case the computation can be performed monthly, although, in this case, the broker-dealer must maintain 105% of the required deposit amount).[34]

Rule 17a–13 requires a broker-dealer that holds securities (proprietary, customer, or both), on a quarterly basis, to examine and count the securities it physically holds, account for the securities that are subject to its control or direction but are not in its physical possession (*e.g.,* securities held at a control location), verify the securities, and compare the results of the count and verification with its records. The broker-dealer must take an operational capital charge under Rule 15c3–1 for all short securities differences (which include securities positions reflected on the broker-dealer's securities record that are not susceptible to either count or confirmation) unresolved after discovery.[35] The differences also must be recorded on the broker-dealer's records.[36]

The Account Statement Rules of DEAs require member broker-dealers to send, at least once every calendar quarter, a statement of account containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last such statement was sent to the customer.[37]

B. Proposed Audit Reports and Changes to Applicable Auditing Standards

As part of the Annual Reporting Amendments, the Commission is proposing changes that would revise the reports that broker-dealers file under Rule 17a–5. While the requirement that broker-dealers file a report consisting of the audited financial statements and supporting schedules that are currently required under Rule 17a–5 (the ''Financial Report'') would remain unchanged, carrying broker-dealers would be required to file a new report asserting to compliance with specified rules and related internal controls (the ''Compliance Report''). These broker-dealers also would be required to file a report from their independent public accountants (the ''Examination Report'') that addresses the assertions in the Compliance Report. Broker-dealers that do not hold customer funds or securities would be required to file a report asserting their exemption from the requirements of Rule 15c3–3 (the ''Exemption Report) and a report from their independent public accountants that would be the result of a review of the broker-dealer's assertion that it is exempt from Rule 15c3–3. Finally, the proposed amendments would change the audit standards applicable to broker-dealer audits and compliance examinations from GAAS to standards promulgated by the PCAOB.

To implement these changes, the Commission proposes a number of amendments to Rule 17a–5. The Commission proposes that paragraph (d) of Rule 17a–5 be re-titled from ''Annual filing of audited financial statements'' to ''Annual reports,'' because under the proposed revisions to paragraph (d), broker-dealers would generally be required to file a Financial Report and a Compliance Report or an Exemption Report with the Commission.[38] Paragraph (d)(1) of Rule 17a–5 would be amended to set forth the general requirement for broker-dealers to file annual financial reports with the Commission. These reports would include: (1) A ''Financial Report'' as described in paragraph (d)(2), which would consist of the audited financial statements and supporting schedules that broker-dealers are currently required to file with the Commission;[39] (2) a Compliance Report as described in paragraph (d)(3) unless the broker-dealer is exempt from the provisions of Rule 15c3–3,[40] or an Exemption Report as described in paragraph (d)(4) if the broker-dealer claims an exemption from the provisions of Rule 15c3–3;[41] and (3) reports prepared by the independent public accountant pursuant to the engagement provisions in paragraph (g), unless the broker-dealer is exempt from the requirement to either file the annual audit report or engage an independent public accountant pursuant to paragraphs (d)(1) and (e)(1) of Rule 17a–5.[42] The proposed requirements for the Compliance Report and Exemption Report are described in greater detail below.

1. Compliance Report

Under the proposed amendments to paragraph (d) of Rule 17a–5, each carrying broker-dealer would be required annually to file a Compliance

[33] *See* Rule 15c3–3(e).

[34] *See* Rule 15c3–3(e)(3).

[35] *See* Rule 15c3–1(c)(2)(v).

[36] *See* Rule 17a–3(a)(4)(vi).

[37] For example, NASD Rule 2340 requires broker-dealers that are members of FINRA that conduct a general securities business to send account statements to customers at least quarterly. The current FINRA rulebook consists of: (1) FINRA rules; (2) NASD rules; and (3) rules incorporated from the NYSE (''Incorporated NYSE Rules'') (together, the NASD rules and Incorporated NYSE Rules are referred to as the ''Transitional Rulebook''). While the NASD rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE. The FINRA rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information *see* FINRA's *Information Notice,* Mar. 12, 2008 (Rulebook Consolidation Process). If a broker-dealer's DEA is the Chicago Board Options Exchange (the ''CBOE''), the broker-dealer would be subject to CBOE's account statement rule, CBOE Rule 9.12.

[38] Paragraph (d) of Rule 17a–5, currently titled ''Annual filing of audited financial statements,'' is being renamed to reflect that the Commission will now require broker-dealers to file two reports with the Commission (*i.e.,* a Financial Report and a Compliance Report, or a Financial Report and an Exemption Report).

[39] Proposed paragraph (d)(1)(i)(A) of Rule 17a–5. *See also* Rule 17a–5(d)(2), which lists the requirements to be included in the Financial Report and would continue to do so because the Commission is not proposing any amendment to the financial statements and supporting schedules required of the broker-dealer. The Commission proposes a technical amendment, to rename the annual audit report to ''Financial Report,'' to reflect that proposed paragraph (d)(2) relates to the financial audit requirements.

[40] Proposed paragraph (d)(1)(i)(B)(1) of Rule 17a–5.

[41] Proposed paragraph (d)(1)(i)(B)(2) of Rule 17a–5.

[42] Proposed paragraph (d)(1)(i)(C) of Rule 17a–5. Specifically, Rule 17a–5(d)(1)(ii) states that ''a broker or dealer succeeding to and continuing the business of another broker or dealer need not file a report * * * if the predecessor broker or dealer has filed a report in compliance with [Rule 17a–5(d)] * * *.'' Rule 17a–5(d)(1)(iii) contains an exemption for broker-dealers from filing an annual audit report if the broker-dealer is a member of a national securities exchange and ''has transacted a business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance or security for any person who is defined as a 'customer' in paragraph (c)(4) of [Rule 17a–5].'' Rule 17a–5(e)(1) provides that for certain broker-dealers, the financial statements that must be filed pursuant to Rule 17a–5(d) need not be audited. The exceptions in paragraphs (e)(1)(A)–(B) of Rule 17a–5 are applicable when either: (1) The broker-dealer's securities business has been limited to acting as broker (agent) for an issuer in soliciting subscriptions for securities of the issuer and the broker has promptly transmitted to the issuer all funds and promptly delivered to the subscriber all securities received in connection with the issuance, and the broker has not otherwise held funds or securities for or owed money or securities to customers; or (2) the broker-dealer's securities business has been limited to buying and selling evidences of indebtedness secured by mortgage, deed or trust, or other lien upon real estate or leasehold interests, and the broker-dealer has not carried any margin account, credit balance or security for any securities customer.

Report containing a statement and assertions concerning compliance, and internal control over compliance, with specified rules. Specifically, the Compliance Report would include a statement as to whether the broker-dealer has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance [43] that any instances of material non-compliance with Rule 15c3–1, Rule 15c3–3, Rule 17a–13, or the Account Statement Rule (collectively, the ''Financial Responsibility Rules'') will be prevented or detected on a timely basis. The Compliance Report is intended to enhance a broker-dealer's focus on compliance with the specified rules and provide a foundation for the proposed ''Compliance Examination'' described below in Section II.B.2 of this release.[44]

In addition, the Compliance Report would include the following three assertions by the broker-dealer: (1) Whether the broker-dealer was in compliance in all material respects with the Financial Responsibility Rules as of its fiscal year-end; [45] (2) whether the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records of the broker-dealer; [46] and (3) whether internal control over compliance with the Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.[47] Further, the Compliance Report would be required to contain a description of each identified instance of material non-compliance and each identified material weakness in internal control over compliance with the specified rules.[48]

Rule 17a–5(g) currently requires that the audit include a review of compliance with and controls pertaining to Rule 15c3–1, Rule 15c3–3, and Rule 17a–13. As described above, these rules contain important baseline protections concerning broker-dealer capital adequacy and the protection of customer funds and securities, and the Commission preliminarily believes that it is important that they be addressed in any annual report of a carrying broker-dealer. The proposed Compliance Report would not cover Regulation T, which is currently addressed in existing Rule 17a–5(g)(1)(iii). The Commission believes that the inclusion of Regulation T in the scope of the Compliance Report would not be necessary given the broker-dealer's assertion in the Compliance Report of its compliance with Rule 15c3–1. In particular, a broker-dealer's failure to comply with Regulation T, which governs broker-dealers' extensions of credit on securities, could require a broker-dealer to reduce its net capital by the amount of any deficit in customer unsecured and partly secured accounts after calls for margin.[49]

The Commission also is proposing to require that the Compliance Report include a statement and three assertions concerning the Account Statement Rule. The Account Statement rule provides a key safeguard for customers by ensuring that they receive on a regular basis information concerning securities positions and other assets held in their accounts. Customers can use that information to identify discrepancies and monitor the performance of their accounts. The Commission believes that, taken together, the objectives of the Compliance Report are consistent with the control objectives of the internal control report required under the IA Custody Rule.[50]

The assertions contained in the Compliance Report would pertain to compliance at year-end and also over the course of a fiscal quarter, depending on the particular requirement.[51] The proposed assertions with respect to compliance with Rules 15c3–1 and 15c3–3 would relate to compliance as of the broker-dealer's fiscal year-end. The assertions as to compliance with Rule 17a–13 and the Account Statement Rule also would be made as of the broker-dealer's fiscal year-end. However, because these rules impose obligations on a quarterly basis (the broker-dealer must conduct the quarterly count of securities and must send statements to all customers at least once during each quarter, but not necessarily on the last day of the quarter), to be able to make the assertions in the Compliance Report, the broker-dealer would need to determine that it had satisfied the requirements over the course of the fiscal quarter immediately preceding the broker-dealer's fiscal year-end. In contrast, the broker-dealer's assertions related to the effectiveness of internal control over compliance with the Financial Responsibility Rules would not pertain to a fixed point in time, but instead would cover the entire fiscal year. The proposed time periods related to internal control over compliance would be consistent with those in the IA Custody Rule.[52]

The Commission preliminarily believes that broker-dealers would be able to make assertions regarding both compliance and the effectiveness of internal control over compliance with the Financial Responsibility Rules. The Commission is *not* proposing that effectiveness of internal control over financial reporting be included as one of the assertions made by the broker-dealer in the Compliance Report.[53] The Commission preliminarily believes that the Compliance Report should focus on oversight of custody arrangements and protection of customer assets, and therefore, should be focused on compliance with the Financial Responsibility Rules.

The proposed amendments to Rule 17a–5 would provide that a broker-dealer could not assert compliance with the Financial Responsibility Rules, as of its most recent fiscal year-end, if it identifies one or more instances of material non-compliance.[54] Instead, the broker-dealer would need to identify and describe any instance of material non-compliance, as of its most recent fiscal year-end, in the Compliance Report.[55] Rule 17a–5 presently requires that independent public accountants include any instances of material inadequacies in their reports based on the Study.[56] The term ''material

[43] Exchange Act Section 13(b)(7) defines ''reasonable assurance'' and ''reasonable detail'' as ''such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.'' 15 U.S.C. 78m(b)(7). The Commission has long held that ''reasonableness'' is not an ''absolute standard of exactitude for corporate records.'' *See Foreign Corrupt Practices Act of 1977*, Exchange Act Release No. 17500 (Jan. 29, 1981), 46 FR 11544, 11546 (Feb. 9, 1981). These concepts differ from the concept of ''reasonable assurance'' in an audit context.

[44] The Compliance Examination is discussed below in Section II.B.2 of this release. As is discussed in Section II.B.2, the Commission does not propose the statement in the Compliance Report to be included within the scope of the Compliance Examination.

[45] *See* proposed paragraph (d)(3)(i)(B)(1) of Rule 17a–5.

[46] *See* proposed paragraph (d)(3)(i)(B)(2) of Rule 17a–5.

[47] *See* proposed paragraph (d)(3)(i)(B)(3) of Rule 17a–5.

[48] *See* proposed paragraph (d)(3)(i)(C) of Rule 17a–5.

[49] *See* Rule 15c3–1(c)(2)(iv)(B).

[50] *See* Section II.B.4 of this release for a discussion of the IA Custody Rule and the control objectives required under the IA Custody Rule.

[51] The broker-dealer is required to be in compliance with the Financial Responsibility Rules at all times. The assertions made by the broker-dealer for purposes of the Compliance Report are as of a point in time to facilitate the independent public accountant's attestation to the broker-dealer's assertions.

[52] *See* Rule 206(4)–2(a)(6).

[53] For example, the Commission is not proposing an assessment of internal control over financial reporting similar to the assessment required under Section 404 of the Sarbanes-Oxley Act for issuers.

[54] *See* proposed paragraph (d)(3)(ii) of Rule 17a–5. The Commission notes that reporting on material non-compliance is discussed, for example, in AT § 601 of the PCAOB's Interim Attestation Standards; *see PCAOB Attestation Standard § 601*.

[55] *See* proposed paragraph (d)(3)(ii) of Rule 17a–5.

[56] *See* Rule 17a–5(g).

inadequacies,'' however, is not defined in existing auditing literature. The Commission is proposing to remove the reference to ''material inadequacies'' in Rule 17a–5 and replace it, for purposes of reporting on the broker-dealer's compliance, with a reference to ''material non-compliance.'' Further, the Commission is proposing to define an instance of material non-compliance, in new paragraph (d)(3)(ii) of Rule 17a–5, as a failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules in all material respects. The Commission preliminarily believes that any failure by the broker-dealer to perform any of the procedures enumerated in the Financial Responsibility Rules would be an instance of non-compliance; therefore, the broker-dealer should evaluate any such failure to determine whether it is material.

When determining whether an instance of non-compliance is material, the Commission preliminarily believes that the broker-dealer should consider all relevant factors including but not limited to: (1) The nature of the compliance requirements, which may or may not be quantifiable in monetary terms; (2) the nature and frequency of non-compliance identified; and (3) qualitative considerations.[57] The Commission also preliminarily believes that some deficiencies would necessarily constitute instances of material non-compliance. For example, failing to maintain the required minimum amount of net capital as required under Rule 15c3–1, or failing to maintain the minimum deposit requirement in a special reserve bank account for the exclusive benefit of customers under Rule 15c3–3,[58] would be instances of material non-compliance. These two instances of material non-compliance would not, however, represent all possible instances of material non-compliance with respect to Rules 15c3–1 and 15c3–3.

The Commission is proposing several conforming amendments to Rule 17a–5 to incorporate the proposed use of the term ''material non-compliance.'' The Commission proposes to amend paragraph (c)(5) of Rule 17a–5, which requires broker-dealers to send Statements of Financial Condition to customers twice per year. Paragraph (c) of Rule 17a–5 provides that a broker-dealer can make these statements available through its Internet Web site in lieu of sending the statements to the customers in paper form.[59] However, paragraph (c)(5)(vi) of Rule 17a–5 prohibits broker-dealers from making the statements available online, in lieu of sending statements to customers in paper form, if the broker-dealer was required by paragraph (e) of Rule 17a–11 to give notice of a material inadequacy. The Commission is proposing to delete the reference to the term ''material inadequacy'' and amend paragraph (c)(5)(vi) of Rule 17a–5 to provide that the broker-dealer may make the customer statements available online, in lieu of sending statements to customers in paper form, provided its financial statements receive an unqualified opinion from the independent public accountant and neither the broker-dealer nor the independent public accountant identifies a material weakness or an instance of material non-compliance pursuant to proposed new paragraph (g) of Rule 17a–5, described below.

The proposed amendments to Rule 17a–5 also would provide that a broker-dealer could not assert that its internal control over compliance with the Financial Responsibility Rules during the fiscal year was effective if one or more material weaknesses exist with respect to internal control over compliance.[60] The Commission preliminarily believes that a broker-dealer's internal control over compliance with the Financial Responsibility Rules would not be effective if a material weakness exists, given the meaning of the term ''material weakness'' as described below. Consequently, if one or more material weaknesses exist, the broker-dealer would need to describe in the Compliance Report each material weakness identified during the fiscal year.[61] This would provide the Commission with notice of the nature of any weakness and allow the Commission and DEA examination staff to ascertain how the broker-dealer addressed each weakness.

The Commission is proposing to define the term ''material weakness'' in paragraph (d)(3)(iii) of Rule 17a–5 as a deficiency, or a combination of deficiencies, in internal control over compliance with the Financial Responsibility Rules, such that there is a reasonable possibility that material non-compliance with those provisions will not be prevented or detected on a timely basis. For purposes of this paragraph, a deficiency in internal control over compliance would exist when the design or operation of a control does not allow the broker-dealer, in the normal course of performing its assigned functions, to prevent or detect non-compliance with the Financial Responsibility Rules on a timely basis.[62] The Commission proposes these definitions, in part, because they are based on previous Commission action.[63]

The Commission preliminarily believes that, for purposes of the proposed definition of the term ''material weakness,'' there is a reasonable possibility of an event occurring if it is ''probable'' or ''reasonably possible.'' An event is ''probable'' if the future event or events are likely to occur.[64] An event is ''reasonably possible'' if the chance of the future event or events occurring is more than remote, but less than likely.[65]

The Commission preliminarily believes that an instance of non-compliance that the broker-dealer has determined does not constitute material non-compliance may nonetheless be indicative of a control deficiency that constitutes a material weakness. The broker-dealer's evaluation of whether an instance of non-compliance is material would be based upon the consideration of the specifically identified instance of non-compliance; whereas the broker-

[57] *See, e.g.,* paragraph 36 of *PCAOB Attestation Standard § 601.*

[58] *See* Section 15(c)(3) of the Exchange Act, which provides that no broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security ''in contravention of such rules and regulations as the Commission shall prescribe * * * to provide safeguards with respect to the financial responsibility and related practices of the brokers and dealers including, but not limited to the acceptable custody and use of customers' securities and the carrying and use of customers' deposits or credit balances.'' 15 U.S.C. 78o(c)(3)(A).

[59] Rule 17a–5 requires that the statements be sent to its customers, except if the activities of the broker-dealer are limited to certain enumerated activities or except as provided in paragraph (c)(5), which permits the broker-dealer to instead make the statements available online if certain requirements are met. *See* Rule 17a–5(c)(1) and (c)(5).

[60] *See* proposed paragraph (d)(3)(iii) of Rule 17a–5.

[61] *See* proposed paragraph (d)(3)(i)(C) of Rule 17a–5.

[62] *See* proposed paragraph (d)(3)(iii) of Rule 17a–5.

[63] *See Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting,* Exchange Act Release No. 55928 (Jun. 27, 2007), 72 FR 35310 (Jun. 27, 2007). *See also* Exchange Act Rule 12b–2 (17 CFR 240.12b–2) and Rule 1–02 of Regulation S–X (17 CFR 210.1–02), which state that a ''material weakness is a deficiency, or a combination of deficiencies, in internal controls over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.''

[64] *See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* Securities Act of 1933 Release No. 8810 (Jun. 20, 2007), 72 FR 35324 (Jun. 27, 2007), at note 47 and corresponding text.

[65] *Id.*

dealer's conclusions with respect to whether the related control deficiency or deficiencies are material weaknesses would relate to whether it is reasonably possible that the control deficiency or deficiencies could result in material non-compliance. This evaluation would require the broker-dealer to consider not only the specifically identified instance of non-compliance but also any additional possible effect that the control deficiency or deficiencies could have on compliance.

The Commission generally requests comment on the proposed amendments associated with the proposed Compliance Report. In addition, the Commission requests comment on the following questions:

- Should other rules be included in the scope of the Compliance Report, in addition to, or as an alternative to, the Financial Responsibility Rules? If so, which rules? Commenters should explain their choices.
- Should the proposed Compliance Report cover Regulation T?
- Are the proposed assertions appropriate? Are there other assertions that the broker-dealer should make regarding either compliance or internal control over compliance? Why would any additional assertions result in improved reporting to the Commission?
- Would all of the proposed assertions achieve the Commission's goals to, among other things, strengthen broker-dealers' compliance with the Financial Responsibility Rules, and, in turn, improve the financial and operational condition of broker-dealers and the safeguarding of investor assets?
- What additional steps would a broker-dealer likely have to take in order to comply with the proposed requirements and make each additional proposed assertion?
- Are there any practical issues the Commission should consider with respect to the proposal to assert compliance with the Financial Responsibility Rules?
- Is the proposed definition of the term ''material non-compliance'' understandable in the context of broker-dealer audits? What alternative definition could be used? Why would any alternative definition be more appropriate?
- Are the examples of material non-compliance described above appropriate? What other examples of material non-compliance should be specifically identified, if any? Should the Commission include examples of material non-compliance in the text of the rule?
- Is the proposed definition of the term ''material weakness'' understandable in the context of Rule 17a–5? What alternative definition could be used? Why would any alternative definition be more appropriate?
- Is the proposed definition of ''deficiency in internal control over compliance'' understandable in the context of Rule 17a–5? What alternative definition could be used? Why would any alternative definition be more appropriate?

2. Compliance Examination and Examination Report

The Commission proposes to require each carrying broker-dealer to engage an independent public accountant to examine the broker-dealer's assertions in the Compliance Report (''Compliance Examination'') and issue an Examination Report. Under the proposal, following the Compliance Examination, carrying broker-dealers would be required to file the resulting Examination Report of the independent public accountant with the Commission. This Compliance Examination and Examination Report would replace the existing practice that results in the independent public accountant issuing a report based on a Study.

The Commission proposes to amend paragraph (g) of Rule 17a–5 and rename it ''Engagement of independent public accountant.'' As proposed, paragraph (g) would provide that a broker-dealer subject to the requirement to file annual reports pursuant to paragraph (d) would need to engage an independent public accountant to examine or review, as applicable, the reports that are required under that provision. Each carrying broker-dealer would be required to engage its independent public accountant to prepare the Examination Report based on an examination of the assertions contained in the Compliance Report required to be filed pursuant to paragraph (d)(3) of Rule 17a–5.[66] The Examination Report would be required to be prepared in accordance with PCAOB standards.[67]

The proposed changes would not affect existing obligations of broker-dealers or their accountants with respect to financial reporting.[68] Further, the assertions in the Compliance Report would not cover the effectiveness of internal control over financial reporting. Therefore, the independent public accountant would *not* be required in the Examination Report to opine on the effectiveness of the broker-dealer's internal control over financial reporting. However, the accountant's existing obligation to gain an understanding and perform appropriate procedures relative to the broker-dealer's internal control over financial reporting, as a necessary part of the independent public accountant's financial statement audit, would remain unchanged.[69] Further, the Examination Report would pertain solely to the assertions in the Compliance Report and *not* to the broker-dealer's process for arriving at the assertions. Because the report of the independent public accountant required by proposed paragraph (g) of Rule 17a–5 would require the accountant to perform its own independent examination of the related controls and procedures, the Commission preliminarily does not believe that it is necessary for the independent public accountant to provide an opinion with regard to the process that the broker-dealer used to arrive at its conclusions.

The Commission preliminarily intends that the proposed amendments and requirements pertaining to the Examination Report would result in the following fundamental changes to broker-dealer audits. First, broker-dealer examinations would be performed in accordance with PCAOB standards, rather than GAAS, consistent with the Dodd-Frank Act.[70] Second, in connection with their engagement, independent public accountants would be required to provide an opinion concerning the broker-dealer's compliance, and internal control over compliance, with key regulatory requirements. Further, the independent public accountant's report, as it applies to internal control over compliance, would cover the full fiscal year instead of relating to the effectiveness of controls only at year-end. Compliance with the Account Statement Rules would be included as part of the review. These changes are intended to encourage, in connection with broker-dealer audits, greater focus by the auditor on internal control over

[66] *See* proposed paragraph (g)(2)(i) of Rule 17a–5.

[67] *Id.* The Commission preliminarily believes that the independent public accountant's examination would be conducted pursuant to existing *PCAOB Attestation Standards* or other standards established by the PCAOB for such purposes.

[68] The Commission is not proposing to change existing requirements with regard to the broker-dealer's audited financial statements, the computation of required and actual net capital under Rule 15c3–1, or, for carrying broker-dealers, the computation of the customer reserve requirement under Rule 15c3–3. The computation of net capital and the computation of the customer reserve requirement would continue to be subject to audit procedures by the accountant.

[69] *See PCAOB Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatements* for audits of fiscal years beginning on or after December 15, 2010.

[70] *See* Section 982 of the Dodd-Frank Act.

compliance as it pertains to key regulatory requirements, including, in particular, greater focus on broker-dealer custody practices under the Financial Responsibility Rules. In addition, the Commission intends that the amendments, as they pertain to custody of customer funds and securities, will better align the broker-dealer custody requirements with certain requirements in the IA Custody Rule.[71]

The Commission generally requests comment on the proposed amendments and, in particular, the Compliance Examination and Examination Report provisions. In addition, the Commission requests comment on the following questions:

- Should the Compliance Examination also cover a broker-dealer's statement in the Compliance Report as to whether the broker-dealer has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance that any instances of material non-compliance with the Financial Responsibility Rules will be prevented or detected on a timely basis? If so, why? If not, why not?
- Should the independent public accountant provide an opinion with regard to the process that the broker-dealer used to arrive at its assertions?

3. Notification Requirements

The proposed amendments would require that the independent public accountant notify the Commission within one business day if the accountant determines that an instance of ''material non-compliance'' exists with respect to any of the Financial Responsibility Rules during the course of the examination.[72] This notice requirement would be triggered at the time that the independent public accountant determines that material non-compliance exists, not at the time of completion of the examination. Alerting the Commission to a broker-dealer's material non-compliance with the Financial Responsibility Rules on an expedited basis could enable the Commission to react to the non-compliance more quickly for the protection of investors and others. Currently, Rule 17a–5 requires notification in the event the independent public accountant determines the existence of a ''material inadequacy.'' [73] Specifically, the independent public accountant must call the material inadequacy to the attention of the broker-dealer's chief financial officer, who is then obligated to notify the Commission and the broker-dealer's DEA.

The Commission proposes modifying the notification requirement to replace the term ''material inadequacy'' with ''material non-compliance'' and to require the independent public accountant to notify the Commission directly. Specifically, the Commission proposes to amend paragraph (h) of Rule 17a–5 to provide that upon determining the existence of any material non-compliance during the course of preparing the independent public accountant's reports, the independent public accountant must notify the Commission within one business day of the determination by means of a facsimile transmission or electronic mail, followed by first class mail, and must provide a copy of the notification in the same manner to the principal office of the DEA for the broker-dealer. The Commission preliminarily believes that this change would provide more effective and timely notice of broker-dealer compliance deficiencies, and, as noted above, enable the Commission to react more quickly to protect customers and others adversely affected by those deficiencies. It also would be consistent with current notification requirements applicable to independent public accountants examining investment advisers pursuant to the IA Custody Rule.[74]

The Commission is proposing a conforming amendment to paragraph (e) of Rule 17a–11, which now requires that broker-dealers provide notice to the Commission of the existence of any material inadequacy. The Commission also is proposing two technical amendments to correct certain references to Rule 17a–12 in paragraph (e) of Rule 17a–11.[75] Further, the Commission is proposing to delete paragraph (h)(1) of Rule 17a–5, which relates to the extent and timing of broker-dealer audits, and which would now be superseded by paragraphs (d) and (g).[76] Finally, the Commission is proposing to delete paragraph (j) of Rule 17a–5, which currently requires the filing of an independent public accountant's report describing any material inadequacies concurrent with the annual audit report. This requirement likewise would be superseded by the proposed amendments.

The Commission generally requests comment on the proposed amendments and the notification provisions. In addition, the Commission requests comment on the following questions:

- Would an alternative means to notify the Commission of an instance of material non-compliance be appropriate? If so, what alternative and why?

4. Comparison to the IA Custody Rule

The IA Custody Rule provides that a registered investment adviser is prohibited from having custody of client funds or securities unless a qualified custodian maintains those funds and securities: (1) In a separate account for each client under that client's name; or (2) in accounts that contain only the investment adviser's clients' funds and securities, under the investment adviser's name as agent or trustee for the clients.[77] Under the IA Custody Rule, only banks, certain savings associations, registered broker-dealers, registered futures commission merchants (''FCMs''),[78] and certain foreign financial institutions may act as qualified custodians.[79]

In addition, when an investment adviser or its related person maintains client funds and securities as qualified custodian in connection with advisory services provided to clients, the adviser annually must obtain, or receive from its related person, a written internal control report prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. This report must be supported by the independent public accountant's examination of the qualified custodian's custody controls.[80] The Commission has

[71] *See* Rule 206(4)–2(a)(6)(ii)(A).

[72] *See* proposed paragraph (h) of Rule 17a–5.

[73] *See* Rule 17a–5(h)(2). ''Material inadequacy'' is not a defined term in existing auditing literature.

[74] *See* Rule 206(4)–2(a)(4)(ii).

[75] Specifically, the Commission proposes to amend the references for Rule 17a–12(f)(2) and Rule 17a–12(e)(2) to be Rule 17a–12(i)(2) and Rule 17a–12(h)(2), respectively.

[76] As discussed above, the broker-dealer must assert that it is in compliance in all material respects with the Financial Responsibility Rules as of the fiscal year-end and that its internal controls over compliance were effective throughout the fiscal year. *See* proposed paragraph (d)(3) of Rule 17a–5.

[77] *See* Rule 206(4)–2(a)(1)(i)–(ii).

[78] FCMs are individuals, associations, partnerships, corporations, and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any exchange and that accept payment from or extend credit to those whose orders are accepted. *See* the Commodity Futures Trading Commission Glossary available at *http://www.cftc.gov.*

[79] For the complete definition of the term ''qualified custodian,'' *see infra* note 154.

[80] The IA Custody Rule provides that the internal control report must include an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the adviser or its related person on behalf of advisory clients, during the year. The rule also

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issued guidance identifying the control objectives that would need to be included in the scope of the examination.[81]

The control objectives identified in the Commission's guidance on the IA Custody Rule are more general than the specific operational requirements in the Financial Responsibility Rules. These general control objectives are appropriate for purposes of the IA Custody Rule, since this approach allows the different types of qualified custodians (banks, certain savings associations, registered broker-dealers, registered FCMs, and certain foreign financial institutions) to establish controls and procedures that meet the identified control objectives in a manner that reflects differences in business models, regulatory requirements, and other factors. For example, the manner in which an FCM maintains custody of assets[82] differs from that of a bank, and the different entities are subject to different regulations governing their custodial functions.

Broker-dealers that maintain custody of customer funds and securities are subject to specific operational requirements in the Financial Responsibility Rules with respect to handling and accounting for customer assets.[83] The Commission preliminarily believes that the operational requirements of those rules are consistent with the control objectives outlined in the Commission's guidance on the IA Custody Rule. Consequently, the Commission has preliminarily determined that, if the proposed rule amendments are adopted, a broker-dealer subject to the proposed Compliance Examination that also acts as a qualified custodian for itself as an investment adviser or for its related investment advisers under the IA Custody Rule would be able to use the Examination Report to satisfy the reporting requirements under Rule 17a–5 and the IA Custody Rule's internal control report requirement.

The Commission generally requests comment on the comparability of the scope of the internal control report under the IA Custody Rule and the scope of the proposed Compliance Examination under the proposed amendments to Rule 17a–5. In addition, the Commission requests comment on the following question:

- Should the Commission add additional elements to the scope of the proposed Examination Report? Commenters should identify any such elements and discuss the feasibility, benefits and costs of including them as elements in the scope of the proposed Compliance Examination.

5. Proposed Exemption Report

As discussed above, broker-dealers claiming an exemption from Rule 15c3–3 (*i.e.,* non-carrying broker-dealers) are required to have their independent public accountants ''ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the [independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination.''[84] The Commission proposes to amend this requirement by requiring a non-carrying broker-dealer claiming an exemption from Rule 15c3–3 to file a new Exemption Report.[85] This Exemption Report would replace the existing requirement described above.

Specifically, under new paragraph (d)(4) of Rule 17a–5, the Exemption Report would require an assertion by a broker-dealer that it is exempt from the provisions of Rule 15c3–3 because it meets one or more of the conditions set forth in paragraph (k) of Rule 15c3–3 with respect to all of its business activities.[86] In addition, the non-carrying broker-dealer would be required to engage an independent public accountant to review the assertion in the Exemption Report and prepare a report based on that review and in accordance with standards of the PCAOB.[87] If the independent public accountant is aware of any material modifications[88] that should be made to the assertion contained in the Exemption Report, the independent public accountant would be required to disclose them in its report. The Commission preliminarily believes that an example of a discovery that would necessitate a material modification would be a discovery that the broker-dealer failed to promptly forward any customer securities it received.[89]

The Commission preliminarily believes that the independent public accountant would be able to obtain the moderate level of assurance contemplated by the required review[90] through a combination of procedures that the accountant would perform in connection with the financial audit currently required under Rule 17a–5[91] and certain inquiries and other procedures targeted specifically to the exemption asserted by the broker-dealer.

The Commission generally requests comment on the proposed Exemption Report. In addition, the Commission requests comment on the following questions:

requires that the accountant ''verify that the funds and securities are reconciled to a custodian other than [the adviser or its] related person.'' The required controls are not enumerated in the rule, however.

[81] *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1942 (Jan. 11, 2010). The Commission guidance on the IA Custody Rule provided the following specified objectives: (1) Documentation for the opening and modification of client accounts is received, authenticated, and established completely, accurately, and timely on the applicable system; (2) client transactions, including contributions and withdrawals, are authorized and processed in a complete, accurate, and timely manner; (3) trades are properly authorized, settled, and recorded completely, accurately, and timely in the client account; (4) new securities and changes to securities are authorized and established in a complete, accurate and timely manner; (5) securities income and corporate action transactions are processed to client accounts in a complete, accurate, and timely manner; (6) physical securities are safeguarded from loss or misappropriation; (7) cash and security positions are reconciled completely, accurately and on a timely basis between the custodian and depositories; and (8) account statements reflecting cash and security positions are provided to clients in a complete, accurate and timely manner.

[82] *See* section 4d(a) and (b) of the Commodity Exchange Act (7 U.S.C. 4d); *see also* 17 CFR 1.20 to 1.30.

[83] While Rule 15c3–1 prescribes broker-dealer net capital requirements, it also contains provisions relating to custody. For example, a broker-dealer must take net capital charges for short security differences unresolved after specifically enumerated timeframes. *See* Rule 15c3–1(c)(2)(v)(A).

[84] *See* Rule 17a–5(g)(2).

[85] A non-carrying broker-dealer would file the Exemption Report and corresponding report prepared by its independent public accountant in lieu of the Compliance Report and Examination Report. The Commission notes, however, that under the IA Custody Rule, a non-carrying or ''introducing'' broker-dealer may be a ''qualified custodian.'' In this case, in order to receive an internal control report that would satisfy the IA Custody Rule, the non-carrying broker-dealer would have to be separately examined by an independent public accountant for that purpose.

[86] *See* Rule 15c3–3(k), which sets forth the exemptions to Rule 15c3–3.

[87] *See* proposed paragraph (g)(2)(ii) of Rule 17a–5.

[88] *See* paragraph 90 of *PCAOB Attestation Standard § 101.*

[89] *See* Rule 15c3–3(k)(2)(ii), which provides that an introducing broker-dealer is exempt from the requirements of Rule 15c3–3 if the introducing broker-dealer ''promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers * * *''

[90] *See* paragraph 55 of *PCAOB Attestation Standard § 101.*

[91] *See* Rule 17a–5(d). As noted previously, the Commission is not proposing to change the requirement that broker-dealers file annual audited financial statements. Therefore, the Commission preliminarily believes that the independent public accountant can leverage the work related to the financial audit in the course of undertaking its review of the broker-dealer's assertion with respect to the claimed exemption from Rule 15c3–3.

• Are there other types of broker-dealers that would not qualify to file an Exemption Report, but, based on the limited scope of their businesses, should be allowed to file a more limited report than the Compliance Report? If so, please identify the types of broker-dealers and indicate why they should not be required to file Compliance Reports.

• What additional processes and controls might a broker-dealer put in place in order to comply with the new requirements relating to the Exemption Report and to accommodate a review of the report by an independent public accountant?

• Should the Commission require that the assertion made by the broker-dealer with respect to the exemption from Rule 15c3–3 be examined by the accountant (*i.e.,* the independent public accountant issues an opinion based on obtaining reasonable assurance) as opposed to being reviewed (*i.e.,* the independent public accountant issues a report based on obtaining a moderate level of assurance)? Commenters should discuss the feasibility, benefits and costs of such a requirement.

• What additional costs and burdens would a non-carrying broker-dealer incur under the proposal requiring an independent public accountant to review the broker-dealer's claim that it qualifies for an exemption from Rule 15c3–3?

6. Change in Applicable Audit Standards

The Commission is proposing to require that the audit of the Financial Report, the examination of the Compliance Report, and the review of the Exemption Report be performed pursuant to standards established by the PCAOB. The Dodd-Frank Act provided authority to the PCAOB to establish, subject to Commission approval, auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms with respect to the preparation and issuance of audit reports to be included in broker-dealer filings with the Commission pursuant to Section 17(e) of the Exchange Act.[92] To enable the PCAOB to effectively implement the authority provided to it by the Dodd-Frank Act, the Commission is proposing to amend paragraph (g) of Rule 17a–5 to provide that the independent public accountants' reports required under the rule must be prepared in accordance with the standards of the PCAOB.[93]

In September 2010, the Commission issued interpretive guidance concerning the auditing standards that should be applied by broker-dealer accountants with respect to the current requirements in Rule 17a–5.[94] That guidance stated that references in Commission rules, staff guidance, and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to non-issuer broker-dealers, should continue to be understood to mean auditing and attestation standards generally accepted in the U.S., in addition to any applicable rules of the Commission.[95]

Because PCAOB auditing standards differ from existing standards governing broker-dealer audits, the proposed change to paragraph (g) would result in a change in the procedures accountants would have to undertake as part of their engagement for audits of broker-dealers. For example, certain audit documentation requirements contained in PCAOB Auditing Standard 3 (*Audit Documentation*) and the engagement quality review requirement in PCAOB Auditing Standard 7 (*Engagement Quality Review*) are not required by GAAS.

The Commission generally requests comment on the proposed change to applicable auditing standards. In addition, the Commission requests comment on the following questions:

• Are there implications to the differences that were identified that the Commission should consider? Are there other differences that exist that would have significant implications to the audits of broker-dealers?

• Should the requirement to be audited in accordance with PCAOB standards be phased in for non-carrying broker-dealers? Why or why not? If so, what time-table should the Commission adopt?

7. Compliance Date and Transition Period

The Commission is proposing to make the Annual Reporting Amendments effective for annual reports filed with the Commission for fiscal years ending on or after December 15, 2011. The Commission is proposing this date to include fiscal years that end on or after December 31, 2011. The Commission preliminarily intends to implement a transition period for carrying broker-dealers required to file Compliance Reports with the Commission with fiscal years ending on or after December 15, 2011 but before September 15, 2012. During this transition period, a carrying broker-dealer's assertion in its Compliance Report as to whether internal control over compliance with the Financial Responsibility Rules was effective would be a point-in-time assertion as of the date of the Compliance Report, rather than covering the broker-dealer's entire fiscal year. The Commission preliminarily believes that the compliance date and transition period set forth above will provide adequate time for broker-dealers to prepare the additional required reports and for independent public accountants to plan and perform the Compliance Examination procedures.

The Commission generally requests comment on the proposed compliance date and transition period. In addition, the Commission requests comment on the following questions:

• Will the proposed compliance date and transition period for the Annual Reporting Amendments provide sufficient time for broker-dealers to prepare the additional reports and for independent public accountants to comply with PCAOB standards? Will it provide sufficient time to plan and perform Compliance Examination procedures? If not, what are the impediments and what would be a more appropriate time frame for implementation?

8. General Solicitation of Comments

The Commission generally requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following questions related to the proposal:

• Certain broker-dealers conducting a limited and specific type of business are not presently required to file an annual audit report.[96] Should the Commission

[92] *See* Section II.A. of this release for a discussion of the PCAOB's new oversight authority under the Dodd-Frank Act.

[93] *See* proposed paragraph (g)(1) of Rule 17a–5.

[94] *See Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers,* Exchange Act Release No. 62991 (Sep. 24, 2010), 75 FR 60616 (Oct. 1, 2010). The Commission also noted in its guidance that it intended to revisit this interpretation in connection with this rulemaking.

[95] *Id.* at 60617.

[96] *See* Rule 17a–5(e)(1)(A) and (B), which provide limited exemptions to broker-dealers from having their financial statements and supporting statements audited by an independent public accountant, so long as specified factors are met (*e.g.,* if the securities business of the broker-dealer has been limited to acting as a broker for an issuer in soliciting subscriptions for securities of such issuer and the broker has promptly transmitted to such issuer all funds and promptly delivered to the subscriber all securities received in connection therewith, and the broker has not otherwise held funds or securities for or owed money or securities to customers, then the broker-dealer does not have to have the financial statements audited by an

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require all broker-dealers to file an annual audit of their financial statements and supporting schedules? Should any of the proposed amendments to Rule 17a–5 applicable to carrying firms be applied to other specific types of broker-dealers? If so, which types of firms and why? What impact would extension of the audit requirement or the proposed amendments relating to non-carrying firms have on small businesses?

C. Proposed Amendment to the Filing of SIPC Reports

1. Existing Requirement

SIPC is a non-profit, membership corporation created under the Securities Investor Protection Act of 1970 (''SIPA'').[97] SIPC is designed to protect the custodial function of a broker-dealer in the event it fails financially. For example, SIPC can fund the liquidation of a broker-dealer that cannot wind itself down in an orderly self-liquidation.[98] As part of the liquidation, SIPC can advance up to $500,000 per customer to satisfy claims for securities and cash.[99] However, of the $500,000, only $250,000 can be used to satisfy claims for cash.[100] In order to pay for these liquidations and advances, SIPC maintains the SIPC Fund.[101] The SIPC Fund is established and maintained by collecting assessments from broker-dealers that are required to be members of SIPC.[102] Generally all broker-dealers registered with the Commission under Section 15(b) of the Exchange Act [103] are required to be members of SIPC.[104] However, broker-dealers engaged exclusively in the distribution of mutual fund shares, the sale of variable annuities, the insurance business, the furnishing of investment advice to investment companies or insurance company separate accounts, or whose principal business is conducted outside the U.S. are not required to be members of SIPC.[105]

Under SIPA, SIPC may assess each of its member broker-dealers a fee determined as a percentage of the firm's revenues.[106] There are required percentage assessments that must be made when the SIPC Fund falls below deposited amounts or such other amount as the Commission may determine in the public interest (''the SIPC Fund Target Level'').[107] SIPC can assess broker-dealers a fee based on a greater percentage of their revenues when the SIPC Fund falls below the SIPC Fund Target Level.[108]

In order to assist in the collection of these assessments, SIPC has promulgated two forms that broker-dealers must file with SIPC, as applicable: Form SIPC–3 and Form SIPC–7. Form SIPC–3 is required when a broker-dealer is claiming an exemption from SIPC membership (*i.e.,* when the broker-dealer does not have to pay an assessment). Such a broker-dealer must file Form SIPC–3 each year certifying that the broker-dealer remained qualified for the exemption during the prior year. Form SIPC–7 elicits information from a broker-dealer that is a SIPC member about the broker-dealer's sources of revenue attributable to its securities business. Every broker-dealer that is a member of SIPC must file this form annually.

When SIPC raises SIPC Fund assessments above the minimum assessment provided for in Section 4(d)(1)(c) of SIPA,[109] Rule 17a–5(e)(4) requires a broker-dealer that files Form SIPC–3 or Form SIPC–7 to also file with the Commission, the broker-dealer's DEA, and SIPC a supplemental report (''Supplemental Report'') covered by an opinion of the broker-dealer's independent public accountant that covers the information in the respective form. Among other things, the Supplemental Report also is required to: (1) Include a statement that the broker-dealer qualified for an exclusion from SIPC membership under SIPA during the prior year if exclusion from membership is claimed; and (2) include an independent public accountant's report stating that ''in the accountant's opinion * * * [the broker-dealer's] claim for exclusion from membership was consistent with income reported'' or ''the assessments were determined fairly in accordance with applicable instructions and forms'' (as applicable).[110]

2. Proposed Amendment

Because Forms SIPC–3 and SIPC–7 are used solely by SIPC for purposes of levying its assessments, the Commission preliminarily believes that Supplemental Reports relating to these forms would be more appropriately filed with SIPC and that SIPC, rather than the Commission, should, by rule, prescribe the form of the Supplemental Reports. This would provide SIPC with the discretion to determine the need for and form of a Supplemental Report and the nature and extent of the review by an independent public accountant, if any. The Commission would continue to have a role in establishing the requirements for a Supplemental Report because the Commission must approve SIPC rule proposals.

The Commission proposes to amend Rule 17a–5 to require that broker-dealers continue to file a Supplemental Report with the Commission, the broker-dealer's DEA, and SIPC until the Commission considers and determines to approve any such rule adopted by SIPC. Because, for an interim period, broker-dealers would be required to continue to file their Supplemental Reports with the Commission, the Commission is proposing to update the rule text to conform it to existing professional standards and industry practices. Specifically, the Commission is proposing to amend Rule 17a–5(e)(4) to eliminate the ambiguity that stems from the differing auditing terms used therein by removing all references to ''review'' and ''opinion'' where those terms are used in Rule 17a–5(e)(4).[111] In their place, the Commission proposes to amend paragraph (e)(4) of Rule 17a–5 to provide that Supplemental Reports shall include the independent public accountant's report prepared pursuant to agreed-upon procedures based on the performance of the procedures outlined in current paragraph (e)(4)(iii) of Rule 17a–5, which the Commission is not proposing to change.[112]

The Commission generally requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following questions related to the proposal:

independent public accountant). *See* Rule 17a–5(e)(1)(A).

[97] 15 U.S.C. 78 *et seq.*

[98] 15 U.S.C. 78eee(a)(3).

[99] 15 U.S.C. 78fff–3(a).

[100] 15 U.S.C. 78fff–3(d).

[101] 15 U.S.C. 78ddd.

[102] 15 U.S.C. 78ddd(c).

[103] 15 U.S.C. 78o(b).

[104] 15 U.S.C. 78ccc(a)(2).

[105] 15 U.S.C. 78ccc(a)(2)(A)(i)–(iii).

[106] *See* 15 U.S.C. 78ddd(c)(2). *See also* SIPC Bylaws, Article 6.

[107] Prior to the Lehman Brothers Inc. and Bernard L. Madoff Investment Securities LLC SIPA liquidations, the SIPC Fund was maintained at a target level of not less than $1 billion. Currently, the SIPC Fund Target Level is $2.5 billion. *See* SIPC Bylaws, Article 6, Section 1(a)(1)(A) (specifying the $2.5 billion SIPC Fund Target Level). *See also* Securities Investor Protection Corporation Modernization Task Force, Adequacy of the SIPC Fund (Jun. 2010), at 5 (describing the increase in the SIPC Fund Target Level from $1 billion to $2.5 billion).

[108] SIPC Bylaws, Article 6, Section 1(a).

[109] 15 U.S.C. 78ddd(d)(1)(c).

[110] *See* Rule 17a–5(e)(4).

[111] *See* Rule 17a–5(e)(4), Rule 17a–5(e)(4)(iii), and Rule 17a–5(e)(4)(iii)(F).

[112] *See* Rule 17a–5(e)(4)(iii). The Commission notes that as part of the proposed amendments to this paragraph, the procedures outlined in current paragraph (e)(4)(iii) of Rule 17a–5 would remain, but would be renumbered to be included in paragraph (e)(4)(ii)(C).

• Should the Commission and/or a broker-dealer's DEA continue to receive SIPC Reports relating to assessments, and, if so, for what reasons?

• Should the Commission continue to require that the broker-dealer engage an independent public accountant to perform some level of work with respect to the information contained in the SIPC Reports? If so, should the Commission also specify what type of engagement the broker-dealer must have with its independent public accountant with respect to the information contained in the SIPC Reports? For example, should the Commission require a broker-dealer to engage its independent public accountant to perform a review of the information in the SIPC Reports pursuant to PCAOB standards? Commenters should discuss the feasibility, benefits, and costs of such requirements.

• Should the Commission impose any requirements or limitations on SIPC with respect to its ability to propose rules to have SIPC Reports filed solely with SIPC? If so, what requirements and/or limitations?

III. The Proposed Access to Audit Documentation Amendments

Pursuant to Section 17(b) of the Exchange Act, broker-dealers are subject to routine inspection and examination by Commission and DEA staff. To facilitate the examination of a broker-dealer that clears transactions or carries customer accounts (a ''clearing broker-dealer''), the Commission is proposing that each clearing broker-dealer be required to consent to permitting its independent public accountant to make available to Commission and DEA examination staff the audit documentation associated with its annual audit reports required under Rule 17a–5 and to discuss findings relating to the audit reports with Commission and DEA examination staff.[113] The Commission preliminarily believes that it is appropriate to limit these requirements to broker-dealers that maintain customer funds and securities or self-custody their proprietary securities because these firms generally have more complex business operations than other broker-dealers. Consequently, having access to audit documentation and the independent public accountants that audit these broker-dealers would be of greater assistance to examiners in performing examinations of these firms, as compared to firms with simpler business models.

The Commission is *not* proposing that the Commission or DEA staff would use any audit documentation they may request, or discuss findings related to the audit reports, for purposes of examining independent public accountants; the PCAOB carries out that function. Rather, the Commission preliminarily intends that any such requests would be made exclusively in connection with conducting a regulatory examination of the clearing broker-dealer.

The Commission preliminarily intends that examiners generally would use any information obtained from audit documentation and discussions with the independent public accountants to establish the scope and focus of a pending examination of a clearing broker-dealer. The Commission preliminarily believes that, in cases in which such information is obtained, it would enhance and improve the efficiency and effectiveness of Commission and DEA examinations of clearing broker-dealers by providing examiners with access to additional relevant information to plan their examinations. This additional relevant information would enable representatives of the Commission and a clearing broker-dealer's DEA to better focus and tailor their examination efforts relating to asset verification and other matters pertinent to customer protection. For example, where an independent public accountant has performed extensive testing of a carrying broker-dealer's custody of funds and securities by confirming holdings at sub-custodians, examiners could focus their efforts on other matters that had not been the subject of prior testing and review.

In connection with these proposals, the Commission is proposing to amend paragraph (f)(2) of Rule 17a–5, which contains the requirement for broker-dealers to file notices with the Commission and their DEAs to designate their independent public accountants, to require that the broker-dealer represent that the engagement of the independent public accountant by the broker-dealer meets the required undertakings of amended paragraph (g).[114] Currently, paragraph (f)(2) of Rule 17a–5 provides that a broker-dealer required to file an annual audit report must file a statement with the Commission and its DEA that it has designated an independent public accountant responsible for performing the annual audit of the broker-dealer, which is called ''Notice pursuant to Rule 17a–5(f)(2)'' (''Notice'').[115] Paragraph (f)(2)(iii) of Rule 17a–5 prescribes the items that are required to be included in the Notice: the name, address, telephone number and registration number of the broker-dealer; the name, address and telephone number of the accounting firm; and the audit date of the broker-dealer for the year covered by the agreement.[116]

The proposed amendments to Rule 17a–5 would require: (1) That the Notice include a statement as to whether the broker-dealer's engagement letter with its independent public accountant is for a single year or is of a continuing nature;[117] (2) a representation that the engagement of the independent public accountant by the broker-dealer meets the required undertakings of paragraph (g);[118] (3) in the case of a clearing broker-dealer, a representation that the broker-dealer agrees to allow representatives of the Commission or the DEA, if requested for purposes of an examination of the broker-dealer, to review the audit documentation associated with the reports of the independent public accountant prepared pursuant to paragraph (g) of Rule 17a–5;[119] and (4) in the case of a clearing broker-dealer, a representation that the broker-dealer agrees to permit the independent public accountant to discuss with representatives of the Commission and the DEA of the broker-dealer, if requested for purposes of an examination of the broker-dealer, the findings associated with the reports of the independent public accountant prepared pursuant to paragraph (g) of Rule 17a–5.[120] Subparagraph (f)(2)(iii) of Rule 17a–5 would provide that a non-clearing broker-dealer is not required to include the third and fourth representations above.[121]

[113] The sole obligation of the broker-dealer under this proposed requirement would be to provide the proposed consent in the manner discussed below. The Commission is not addressing in this release any rights, obligations, or responsibilities of a broker-dealer's independent public accountant with respect to its work papers.

[114] *See* proposed paragraph (f)(2)(ii)(E) of Rule 17a–5.

[115] *See* Rule 17a–5(f)(2).

[116] *See* Rule 17a–5(f)(2)(iii)(A) through (C).

[117] *See* proposed paragraph (f)(2)(ii)(D) of Rule 17a–5. The Commission notes that FINRA currently provides its members with a template for the Rule 17a–5(f)(2) Notice that includes a provision as to whether the engagement is continuing in nature, which is available at *http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/industry/p009841.pdf.*

[118] *See* proposed paragraph (f)(2)(ii)(E) of Rule 17a–5.

[119] *See* proposed paragraph (f)(2)(ii)(F) of Rule 17a–5.

[120] *See* proposed paragraph (f)(2)(ii)(G) of Rule 17a–5.

[121] *See* proposed paragraph (f)(2)(iii) of Rule 17a–5, which would provide that a ''broker or dealer who does not carry nor clear transactions nor carry

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The Commission also is proposing several technical changes to paragraph (f)(2) of Rule 17a–5. Specifically, the Commission proposes to amend the language in the preamble of paragraph (f)(2) to streamline the paragraph and to add a reference to the requirements of the Notice. The Commission proposes to delete paragraph (f)(2)(ii), which provides that the agreement can be continuing in nature, because the amended preamble to paragraph (f)(2) captures this concept.

If the Access to Audit Documentation Amendments described above were adopted, Notices on file with the Commission at the time of the effectiveness of the amendment would not be in compliance with the new rules. Accordingly, broker-dealers subject to paragraph (f)(2) would have to file new Notices if the proposals were adopted. However, if the engagement covered by the new Notice was of a continuing nature, no subsequent filing would be required unless the broker-dealer changed independent public accountants.[122]

The Commission generally requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following questions:

- Should the proposed Access to Audit Documentation Amendments apply to all broker-dealers, or additional broker-dealers rather than just clearing broker-dealers?
- Would applying the proposed Access to Audit Documentation Amendments to non-clearing broker-dealers provide any advantages in terms of enhancing the examination of the broker-dealers or gaining efficiencies?
- Are there any other types of broker-dealers whose conduct may pose risks to the investing public that should be subject to the proposed Access to Audit Documentation Amendments?
- Are there additional reasons why examiners should obtain documentation from independent public accountants other than those described above (*i.e.,* to establish the scope and focus of a pending examination of a clearing broker-dealer)? If so, please explain the reasons and the objectives behind the reasons and how the information could be used to achieve those objectives.
- Would any limitations on the ability of examiners to have access to audit documentation or to discuss the findings of the independent public accountant be appropriate? If so, what are those restrictions, why would they be appropriate, and what effect would they have on broker-dealer examinations?
- Should examiners be required to request access to the audit documentation in writing?
- Should the Commission require a broker-dealer to submit a statement consenting to provide access to its independent public accountant and the audit documentation (''statement of consent'') only when it files the ''Notice pursuant to Rule 17a–5(f)(2)''?
- How often should the statement of consent be filed (*e.g.,* on an annual or more frequent basis)?
- Are the proposed representations in the Notice sufficient to provide effective access to the independent public accountant's audit documentation? If not, what additional representations, or what other measures, would be more effective?
- Will the terms of engagement between clearing broker-dealers and their independent public accountants, including compensation terms, be affected by the proposed amendments? What additional costs might this place on clearing broker-dealers? In this respect, would there be a disproportionate impact on smaller clearing broker-dealers?
- What is the risk, if any, that clearing broker-dealers and their current independent public accountants will not be able to agree on mutually-agreeable terms in order to compensate them for additional burdens they may incur as a result of the proposed amendments?

IV. The Proposed Form Custody Amendments

The Commission has brought numerous enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct that includes misappropriation or other misuse of customer assets.[123] Consequently, the Commission recently took steps to enhance oversight of the custody function of investment advisers,[124] and is now proposing enhancements to the oversight of the custody function of broker-dealers. The Commission is proposing amendments to Rule 17a–5 that are designed to provide greater information regarding the custody function at broker-dealers and their compliance with requirements relating to custody of customer and non-customer assets. Specifically, the Commission is proposing a new form to be filed by broker-dealers—Form Custody—which is designed to elicit information concerning whether a broker-dealer maintains custody of customer and non-customer assets, and, if so, how such assets are maintained.[125] As discussed below, the Commission proposes to require that a broker-dealer file proposed Form Custody with its quarterly FOCUS Report.[126]

Currently, a broker-dealer's FOCUS Report provides the Commission and other regulators (*e.g.,* a broker-dealer's DEA) with information relating to the broker-dealer's financial and operational condition.[127] A broker-dealer's FOCUS Report does not, however, solicit

customer accounts is not required to include the representations in paragraph (e)(ii)(F).''

[122] *See* Rule 17a–5(f)(2)(ii).

[123] *See, e.g., SEC* v. *Donald Anthony Walker Young, et al.,* Litigation Release No. 21006 (Apr. 20, 2009) (complaint alleges registered investment adviser and its principal misappropriated in excess of $23 million, provided false account statements to investors in limited partnership, and provided false custodial statements to limited partnership's introducing broker); *SEC* v. *Isaac I. Ovid, et al,* Litigation Release No. 20998 (Apr. 14, 2009) (complaint alleges that defendants, including registered investment adviser and manager of purported hedge funds, misappropriated in excess of $12 million); *SEC* v. *The Nutmeg Group, LLC, et al.,* Litigation Release No. 20972 (Mar. 25, 2009) (complaint alleges that registered investment adviser misappropriated in excess of $4 million of client assets, failed to maintain client assets with a qualified custodian, and failed to obtain a surprise examination); *SEC* v. *WG Trading Investors, L.P., et al.,* Litigation Release No. 20912 (Feb. 25, 2009) (complaint alleges that registered broker-dealer and affiliated registered adviser orchestrated fraudulent investment scheme, including misappropriating as much as $554 million of the $667 million invested by clients and sending clients misleading account information); *SEC* v. *Stanford International Bank, et al.,* Litigation Release No. 20901 (Feb. 17, 2009) (complaint alleges that affiliated bank, broker-dealer, and advisers colluded with each other in carrying out an $8 billion fraud); *SEC* v. *Bernard L. Madoff, et al.,* Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Madoff and Bernard L. Madoff Investment Securities LLC—a registered investment adviser and registered broker-dealer—committed a $50 billion fraud).

[124] *See, e.g., Custody of Funds or Securities by Investment Advisers,* Advisers Act Release No. 2968 (Dec. 30, 2009), 75 FR 1456 (Jan. 11, 2010).

[125] For purposes of Form Custody, the term ''customer'' means a person that is a ''customer'' for purposes of Rule 15c3–3(a), and a ''non-customer'' means a person other than a ''customer'' as that term is defined in Rule 15c3–3(a). *See* Rule 15c3–3(a) and FINRA's Interpretations of Financial and Operational Rules, Rule 15c3–3, Rule 15c3–3(a)(1)/01, available on FINRA's Internet Web site at *http://www.finra.org/Industry/Regulation/Guidance/FOR/.*

[126] *See* Rule 17a–5(a). FOCUS Reports, filed with the Commission and SROs by broker-dealers, are one of the primary means of monitoring the financial and operational condition of broker-dealers and enforcing the broker-dealer financial responsibility rules. The completed forms are also used to determine which firms are engaged in various securities-related activities, and how economic events and government policies might affect various segments of the securities industry. The FOCUS Report was designed to eliminate overlapping regulatory reports required by various SROs and the Commission and to reduce reporting burdens as much as possible. *See supra* note 20. The Commission notes that FOCUS Reports are, and proposed Form Custody would be, deemed to be confidential pursuant to paragraph (a)(3) of Rule 17a–5.

[127] *See* Form X–17A–5 Schedule I, Part II, Part IIa, Part IIb, and Part III.

detailed information on how a broker-dealer maintains custody of assets. The proposed new form is intended to provide additional information about a broker-dealer's custodial activities. The Commission preliminarily believes that proposed Form Custody could make it easier for examiners to determine whether broker-dealers are in compliance with laws and regulations concerning the custody of assets. If, upon reviewing Form Custody, regulatory authorities became aware of inconsistencies or other red flags in information contained in the form, they could initiate a more detailed and focused analysis of the broker-dealer's custodial activities. Such an analysis may, in turn, identify potential abuses related to customer assets. Moreover, proposed Form Custody could expedite the examination of a broker-dealer's custodial activities and reduce examination costs, as examiners would no longer need to request basic custody-related information already disclosed on the form.

The Commission is proposing that broker-dealers file Form Custody with their quarterly FOCUS Reports. The Commission preliminarily believes that Form Custody would help provide applicable regulators with current information about a broker-dealer's custodial activities and, as described below, would promote compliance with applicable laws and rules. The Commission is proposing that Form Custody be filed on a quarterly basis to ensure that the information disclosed on the form is current and to enable examiners to identify significant recent changes in a broker-dealer's custody practices. For example, examiners could more promptly investigate instances in which a broker-dealer frequently changes the locations where customer securities are held. While a broker-dealer may have valid and lawful reasons for changes in the custody arrangements for its customers' securities, such actions also could suggest improper activity and could cause examiners to make further inquiries.

Proposed Form Custody is comprised of nine line items (each, an ''Item'') that elicit information about a broker-dealer's custodial activities. Several Items contain multiple questions, and a few Items require completion of charts and disclosure of custody-related information specific to the broker-dealer completing the form. Each Item and its subparts are discussed below.

A. Item 1—Accounts Introduced on a Fully Disclosed Basis

Item 1.A of Form Custody would elicit information concerning whether the broker-dealer introduces customer accounts to another broker-dealer on a fully disclosed basis by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box. Many broker-dealers enter into agreements (''carrying agreements'') with another broker-dealer in which the two firms allocate certain responsibilities with respect to the handling of accounts.[128] These carrying agreements are governed by applicable self-regulatory organization (''SRO'') rules, which require broker-dealers entering into a carrying agreement to allocate certain responsibilities associated with introduced accounts.[129]

Typically, under a carrying agreement, one broker-dealer (the ''introducing broker-dealer'') agrees to act as the customer's account representative (*e.g.,* by providing the customer with account opening documents, ascertaining the customer's investment objectives, and making investment recommendations). The carrying broker-dealer typically agrees to receive and hold the customer's cash and securities, clear transactions, make and retain records relating to the transactions and the receipt and holding of assets, and extend credit to the customer in connection with the customer's securities transactions.

Proposed Item 1.A would elicit information concerning whether the broker-dealer introduces customer accounts to another broker-dealer on a fully disclosed basis, rather than asking whether the broker-dealer is an ''introducing broker-dealer.'' The Commission is proposing the question in this manner because some broker-dealers operate as carrying broker-dealers (*i.e.,* they hold cash and securities) for one group of customers but also introduce the accounts of a second group of customers on a fully disclosed basis to another broker-dealer. For example, a broker-dealer may incur the capital expense and cost of acting as a carrying broker-dealer for certain products (*e.g.,* equities) but not for other products (*e.g.,* options). In this case, the firm operates as a hybrid introducing/carrying broker-dealer by introducing on a fully disclosed basis to a carrying broker-dealer those customers that trade securities the broker-dealer is not equipped to maintain. Broker-dealers also may introduce customer accounts on an omnibus basis, as is discussed in detail in Section IV.B. of this release.

If the broker-dealer answers Item 1.A by checking the ''Yes'' box, the broker-dealer would be required under Item 1.B to identify each broker-dealer to which customer accounts are introduced. As discussed above, the carrying broker-dealer in such an arrangement maintains the cash and securities of the introduced customers. Consequently, Item 1.B would elicit the identity of each broker-dealer obligated to return cash and securities to the introduced customers. Commission and DEA examiners could use this information to confirm the existence of an introducing/carrying relationship and to confirm that the carrying broker-dealer acknowledges its obligation to return the cash and securities belonging to the introduced customers.[130]

The Commission generally requests comment on all aspects of proposed Item 1. In addition, the Commission requests comment on the following questions relating to proposed Items 1.A and 1.B:

- Should the Commission require additional information about accounts introduced to carrying broker-dealers on a fully disclosed basis? If so, what type of information?
- Should the Commission require the broker-dealer to disclose the number of accounts it introduces on a fully disclosed basis?
- Should the Commission require the broker-dealer to disclose the approximate dollar amount of assets held in fully disclosed accounts at the carrying broker-dealer?
- Should the Commission solicit information as to whether a broker-dealer other than the carrying broker-dealer clears transactions that are ultimately maintained by the carrying broker-dealer on a fully disclosed basis?
- Should the Commission require the broker-dealer to identify whether it relies on the carrying broker-dealer or another third party to maintain books and records relating to introduced accounts?

B. Item 2—Accounts Introduced on an Omnibus Basis

Item 2.A would elicit information concerning whether the broker-dealer

[128] To be consistent with the definition of the term ''customer'' in Rule 15c3–3, the Commission proposes to define the term ''customer'' in the General Instructions to Form Custody the same. *See* Rule 15c3–3(a)(1).

[129] *See, e.g.,* NYSE Rule 382, NASD Rule 3230, and FINRA Rule 4311.

[130] *See* Letter from Richard G. Ketchum, Director, Division of Market Regulation, Commission, to David Marcus, New York Stock Exchange (Jan. 14, 1985), which states that the customers of introducing broker-dealers are presumed to be customers of the clearing broker-dealer for purposes of the Commission's financial responsibility rules and SIPA.

introduces customer accounts to another broker-dealer on an omnibus basis by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box. An omnibus account is an account carried and cleared by another broker-dealer that contains accounts of undisclosed customers on a commingled basis and that are carried individually on the books of the broker-dealer introducing the accounts.[131] Disclosure of this information is important because a broker-dealer that introduces customer accounts to another broker-dealer on an omnibus basis is considered to be a carrying broker-dealer with respect to those accounts under the Commission's broker-dealer financial responsibility rules.[132] Thus, in these arrangements, the broker-dealer introducing the omnibus account to a carrying broker-dealer is obligated to return cash and securities in the account to customers.[133]

If the broker-dealer checks the ''Yes'' box in Item 2.A, it would be required to identify in Item 2.B each broker-dealer to which accounts are introduced on an omnibus basis. Commission and DEA examiners could use this information to confirm whether the cash and securities introduced to the carrying broker-dealer are in fact being held in an omnibus account at the carrying broker-dealer.

The Commission generally requests comment on all aspects of proposed Item 2. In addition, the Commission requests comment on the following questions relating to proposed Items 2.A and 2.B:

- Should the Commission require additional information about accounts introduced to carrying broker-dealers on an omnibus basis? For example, should the Commission require a broker-dealer to provide information about the specific types of products or customers introduced to a carrying broker-dealer on an omnibus basis? What other information about accounts introduced to carrying- broker-dealers on an omnibus basis should the Commission require to be disclosed? Why?
- Should the Commission require a broker-dealer to disclose the number of omnibus accounts it introduces to other broker-dealers? If yes, please explain why. If no, please explain why not.
- Should the Commission require a broker-dealer to disclose the approximate dollar amount of assets held in omnibus accounts at the carrying broker-dealer? If yes, please explain why. If no, please explain why not.
- Should the Commission solicit information as to whether a broker-dealer other than the carrying broker-dealer clears transactions where the securities are ultimately maintained by the carrying broker-dealer on an omnibus basis? If yes, please explain why. If no, please explain why not.

C. Item 3—Carrying Broker-Dealers

1. Items 3.A and 3.B

Item 3 elicits information concerning how a carrying broker-dealer holds cash and securities. Item 3 is comprised of five subparts. The first question—Item 3.A—elicits information concerning whether the broker-dealer carries securities accounts for customers by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box. As noted above, the proposed General Instructions to Form Custody would specify that the term ''customer'' as used in the Form means a ''customer'' as defined in Rule 15c3–3. The next question—Item 3.B—elicits information concerning whether the broker-dealer carries securities accounts for persons that are not ''customers'' under the definition in Rule 15c3–3. For example, under Rule 15c3–3, persons that are not ''customers'' include an accountholder that is a general partner, director, or principal officer of the carrying broker-dealer and accountholders that are themselves broker-dealers.

2. Item 3.C

Item 3.C requires the broker-dealer to identify in three charts the types of locations where it holds securities and the frequency with which it performs reconciliations between the information on its stock record and information on the records of those locations. The proposed instructions to Item 3.C provide that the broker-dealer must identify the types of locations where it holds securities. The broker-dealer would be required to identify locations that are used at any one time for maintaining customer, non-customer, and proprietary securities. The proposed instructions also require the broker-dealer to specify the locations where the broker-dealer holds securities directly in the name of the broker-dealer (*i.e.,* the broker-dealer should not identify a type of location if the broker-dealer only holds securities at the location through an intermediary). For example, when a broker-dealer is not a member of a securities clearing organization but, instead, accesses the securities processing facilities of the organization by holding securities at an entity that is a member of the organization (*e.g.,* a U.S. bank), the broker-dealer would be required to identify the category of location for which the broker-dealer has a direct custodial relationship (*i.e.,* the U.S. bank), but not the securities clearing organization.

The first chart—set forth in Item 3.C.i—identifies the most common locations where broker-dealers hold securities. Many of the locations identified on the first chart, and described below, are locations deemed to be satisfactory control locations under paragraph (c) of Rule 15c3–3.

The first location identified in the chart is the broker-dealer's vault. As noted above, broker-dealers primarily hold securities in fungible bulk at other institutions. In some cases, however, broker-dealers may physically hold securities certificates (*e.g.,* in the case of restricted securities).

The second location identified in the chart is another U.S. registered broker-dealer. For example, a broker-dealer may hold customers' foreign securities at another U.S. broker-dealer, or may hold securities in an omnibus account at another broker-dealer.

The third and fourth potential locations identified in the chart are the Depository Trust Company (''DTC'') and the Options Clearing Corporation. These are two of the predominant securities clearing organizations in the U.S. and, consequently, are identified by name rather than type.

The fifth potential location identified in the chart is a U.S. bank. Broker-dealers may have arrangements with U.S. banks to receive and hold securities for the accounts of the broker-dealer's customers and non-customers, as well as for the broker-dealer's own account. Obtaining information about a broker-dealer's relationships with U.S. banks could enable examiners to test and confirm the accuracy of the broker-dealer's representations on proposed Form Custody (*i.e.,* that a U.S. bank holds securities for the broker-dealer), and in addition facilitate the collection of information regarding the relationship between the broker-dealer and the bank. For instance, customer fully paid and excess margin securities cannot be pledged as collateral for a loan to the broker-dealer, and customer margin securities may not be commingled with proprietary securities that are pledged as collateral for a bank loan. Form Custody could, for example, lead examiners to seek account statements and documentation governing the broker-dealer's relationship with the U.S. bank to ensure customer fully paid and excess

[131] *See* Broker-Dealer Audit Guide, *supra* note 14.

[132] *See Net Capital Rule,* Exchange Act Release No. 31511 (Nov. 24, 1992); 57 FR 56973 (Dec. 2, 1992), n. 16.

[133] *Id.*

margin securities are not pledged as collateral.

The sixth potential location identified in the chart is the transfer agent of an open-end investment management company registered under the Investment Company Act of 1940 (*i.e.,* a mutual fund). Generally, mutual funds issue securities only in book entry form. This means that the ownership of securities is not reflected on a certificate that can be transferred but rather through a journal entry on the books of the issuer maintained by the issuer's transfer agent. A broker-dealer that holds mutual funds for customers would hold them in the broker-dealer's name on the books of the mutual fund.

The second chart—set forth in Item 3.C.ii—is intended to capture all other types of U.S. locations where a broker-dealer may hold securities that are not specified in the chart included in Item 3.C.i. This could include securities held in book-entry form by the issuer of the securities or the issuer's transfer agent. A broker-dealer that holds securities in such locations would be required to list the types of locations in the spaces provided in the chart and indicate the frequency with which the broker-dealer performs asset reconciliations with those locations.

The third chart—set forth in Item 3.C.iii—pertains to foreign locations where the broker-dealer maintains securities. The Commission is not proposing to list categories of foreign locations because terminology used to identify certain locations may differ by jurisdiction. For example, in some foreign jurisdictions, banks may operate a securities business, making it difficult to classify whether securities are held at a bank or a broker-dealer. A broker-dealer that holds securities in a foreign location would be required to list the types of foreign locations where it maintains securities in the spaces provided in the chart and indicate the frequency with which reconciliations are performed with the location.

3. Items 3.D and 3.E

Items 3.D and 3.E of proposed Form Custody each have three identical subparts that elicit information about the types and amounts of securities and cash the broker-dealer holds, whether those securities are recorded on the broker-dealer's stock record and, if not, why they are not recorded, and where the broker-dealer holds free credit balances. The General Instructions to proposed Form Custody would define ''free credit balances'' as liabilities of a broker-dealer to customers or non-customers which are subject to immediate cash payment to customers or non-customers on demand, whether resulting from sales of securities, dividends, interest, deposits, or otherwise.[134]

The difference between Item 3.D and Item 3.E is that the former would elicit information with respect to securities and free credit balances held for the accounts of customers, whereas the latter would elicit information with respect to securities and free credit balances held for the accounts of persons that are not customers.[135] Accordingly, the form would ask two sets of identical questions to elicit information about each category of accountholder—customer and non-customer.

Proposed Items 3.D.i and 3.E.i would elicit information about the types and dollar amounts of the securities the broker-dealer carries for the accounts of customers and non-customers, respectively. Specifically, for each Item, the broker-dealer would be required to complete information on a chart to the extent applicable. The charts have twelve rows, with each row representing a category of security. The categories are: (1) U.S. Equity Securities; (2) Foreign Equity Securities; (3) U.S. Listed Options; (4) Foreign Listed Options; (5) Domestic Corporate Debt; (6) Foreign Corporate Debt; (7) U.S. Public Finance Debt; (8) Foreign Public Finance Debt; (9) U.S. Government Debt; (10) Foreign Sovereign Debt; (11) U.S. Structured Debt; and (12) Foreign Structured Debt. A thirteenth row is included in each chart to identify any securities not specifically listed in the first twelve rows. The types of securities are categorized this way because the various categories ordinarily are associated with certain types of locations. Thus, as examiners review the form, they could assess whether the types of securities held by the broker-dealer are maintained at locations generally known to hold such securities. If the form indicates that some types of securities are held at a location that is atypical for such securities, the examiner can refine the focus of the examination to ensure customer assets are properly safeguarded.

The charts in Items 3.D.i and 3.E.i each have eight columns. The first column contains boxes for each category of security specified in the Item. The broker-dealer would be required to check the box in each chart for every applicable category of security it holds for the accounts of customers and non-customers, respectively. The second column identifies the category of security. The third through eighth columns represent ranges of dollar values: (1) Up to $50 million; (2) greater than $50 million up to $100 million; (3) greater than $100 million up to $500 million; (4) greater than $500 million up to $1 billion; (5) greater than $1 billion up to $5 billion; and (6) greater than $5 billion. The broker-dealer would be required to check the box in each chart reflecting the approximate dollar value for every category of security the broker-dealer carries for the accounts of customers and non-customers, respectively.

The Commission is proposing dollar ranges for the values of the securities, as opposed to actual values, to ease compliance burdens. The intent is to elicit information about the relative dollar value of securities the broker-dealer holds for customers and non-customers in each category of security. Values would be reported as of the date specified in the broker-dealer's accompanying quarterly FOCUS Report.

Proposed Items 3.D.ii and 3.E.ii would elicit information concerning whether the broker-dealer has recorded all the securities it carries for the accounts of customers and non-customers, respectively, on its stock record by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box. If the broker-dealer checks ''No,'' it would be required to explain in the space provided why it has not recorded such securities on its stock record and indicate the type of securities and approximate U.S. dollar market value of such unrecorded securities.

The Commission anticipates that a broker-dealer would answer ''Yes'' in response to Items 3.D.ii and 3.E.ii because the stock record—which a broker-dealer is required to create pursuant to Rule 17a–3—is a record of custody and movements of securities. A long position in the stock record indicates ownership of the security or a right to the possession of the security. Thus, the ''long side'' of the stock record indicates the person to whom the broker-dealer owes the securities. Common examples of ''long side'' positions are securities received from customers (*e.g.,* fully paid or excess margin securities), securities owned by the firm (*i.e.,* securities held in the

[134] This definition is similar to the definition of the term ''free credit balance'' in Rule 15c3–3, except that the definition in the rule is limited to liabilities to ''customers'' whereas the definition in the proposed Form contemplates liabilities to customers and non-customers. *See* Rule 15c3–3(a)(8).

[135] As discussed above, the term ''customer'' on proposed Form Custody would mean a ''customer'' as defined in Rule 15c3–3(a)(1). Broker-dealers may carry securities accounts for ''customers'' as defined in Rule 15c3–3 and for persons that are not customers (such as insiders and other broker-dealers).

broker-dealer's inventory for its own account), securities borrowed, and fails-to-deliver (*i.e.,* securities sold to or through another broker-dealer but not delivered).

A short position in the stock record indicates either the location of the securities or the responsibility of other parties to deliver the securities to the broker-dealer. Every security owned or held by the broker-dealer must be accounted for by its location. Since securities are fungible, the short side of the stock record does not in fact designate where particular securities are located. Rather, it indicates the total amount of securities, on a security-by-security basis, held at each location, which could include, for example, securities depositories. Common short-side stock record locations also include banks (*e.g.,* when a broker-dealer pledges securities to a bank as collateral for a loan), stock loan counterparties (*e.g.,* when a broker-dealer lends securities to another firm as part of a securities lending transaction), and counterparties failing to deliver securities to the broker-dealer (*e.g.,* when the broker-dealer has purchased securities that have not yet been received from the counterparty).

The Commission's goals in proposing this question are twofold. First, the question could elicit the disclosure of the unusual circumstance in which a broker-dealer carries securities for the account of a customer or non-customer but does not reflect them on its stock record. The Commission and other securities regulators could use this information to assess whether the broker-dealer is properly accounting for securities. Second, this question could prompt a broker-dealer to identify, and self-correct, circumstances in which it did not include securities on its stock record as required by Rule 17a–3.

Proposed Items 3.D.iii and 3.E.iii would elicit information as to how the broker-dealer treats free credit balances in securities accounts of customers and non-customers, respectively. The information is elicited through a chart the broker-dealer would be required to complete. The chart in Item 3.D.iii has five rows with each row representing a different process for treating free credit balances. The treatment options (referred to as ''processes'' on the form) would be that free credit balances are: (1) Included in a computation under Rule 15c3–3(e); (2) held in a bank account under Rule 15c3–3(k)(2)(i); (3) swept to a U.S. bank; (4) swept to a U.S. money market fund; and (5) ''other,'' with a space to describe such other treatment. The options are not intended to be mutually exclusive in that a broker-dealer may treat free credit balances in several different ways (*e.g.,* a broker-dealer may be instructed by certain customers to sweep their free credit balances to a bank, and by other customers to sweep their free credit balances to a U.S. money market fund).

A broker-dealer would be required to check the box in the first column of the chart for every process that applies to the broker-dealer's treatment of free credit balances in customer and non-customer accounts, respectively. The first process identified on each chart is that the broker-dealer treats customer and non-customer free credit balances in accordance with the customer reserve computation required under Rule 15c3–3(e). Rule 15c3–3(e) requires a broker-dealer to maintain a special reserve bank account for the exclusive benefit of its customers and maintain deposits in that account (to the extent a deposit is required) in amounts computed in accordance with Exhibit A to Rule 15c3–3.[136] Rule 15c3–3 requires a broker-dealer to comply with these reserve account provisions only with respect to customer-related credit balances. The Commission has, however, proposed amendments to Rule 15c3–3 that would require a broker-dealer to maintain a reserve account and perform a reserve computation for non-customer accountholders that are domestic and foreign broker-dealers.[137]

The second process identified on the chart is that the broker-dealer handles free credit balances by placing funds in a ''bank account under Rule 15c3–3(k)(2)(i).'' Rule 15c3–3(k)(2)(i) prescribes a process by which a broker-dealer can qualify for an exemption from the requirements of Rule 15c3–3. Specifically, the exemption applies to a broker-dealer that does not carry margin accounts, promptly transmits all customer funds and delivers all securities received in connection with its activities, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker-dealer and its customers through one or more bank accounts that are each designated as a ''Special Account for the Exclusive Benefit of Customers of (the name of broker or dealer).'' [138]

The third process identified in the chart—''swept to a U.S. bank''—is included because some broker-dealers engage in ''Bank Sweep Programs.'' Rather than hold customer funds in securities accounts, some broker-dealers require or offer the option to transfer free credit balances in securities accounts to a specific money market fund or interest bearing bank account (''Sweep Programs''). The customer earns dividends on the money market fund or interest on the bank account until such time as the customer chooses to liquidate the position in order to use the cash, for example, to purchase securities.[139] Customers must make a request to the broker-dealer for the return of funds swept from their securities accounts to the bank.

The fourth option identified in the chart is that the broker-dealer sweeps free credit balances into a money market fund as part of a Sweep Program. In most cases when a broker-dealer sweeps free credit balances into a money market fund, the broker-dealer purchases shares in the money market fund, which is registered in the name of the broker-dealer. The money market fund understands that these shares are not proprietary positions of the broker-dealer, and any interest earned on the shares from the money market fund are payable to the customers.

Finally, the fifth option in the chart would cover any other process that is not described in the other options.

The Commission generally requests comment on all aspects of proposed Item 3. In addition, the Commission requests comment on the following questions relating to proposed Item 3:

- Should the Commission identify additional U.S. locations in Item 3.C.i relating to where broker-dealers maintain custody of securities held in the U.S.?
- Should the Commission include separate charts to identify locations where customer, non-customer, and proprietary securities are held?
- Should the charts in Item 3.C solicit information from broker-dealers other than the location where securities are held and reconciliation frequency?
- Should the broker-dealer be required to identify only the types of locations in Items 3.C.i, ii and iii where un-hypothecated securities are located? For example, should the broker-dealer not be required to identify locations where securities are hypothecated in transactions such as stock loans, bank loans and repurchase agreements?

[136] *See* Rule 15c3–3(e) and Rule 15c3–3a.

[137] *See Amendments to Financial Responsibility Rules for Broker-Dealers,* Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007). *See also* Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, NYSE, and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998).

[138] *See* Rule 15c3–3(k)(2)(i).

[139] *See Amendments to Financial Responsibility Rules for Broker-Dealers,* Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007) at 12866.

• Should the Commission identify additional categories of securities in the charts specified under Item 3.D and 3.E? For example, are the securities listed on those charts sufficiently comprehensive to cover most, if not all, types of securities carried by broker-dealers?

• Should the Commission require the broker-dealer to provide the identities of all custodians, as opposed to, or in addition to, describing the types of custodians?

• Should the Commission use different dollar ranges in the charts specified in Items 3.D.i and 3.E.i? If so, what ranges?

• Should the Commission require broker-dealers to provide specific dollar amounts, rather than indicating ranges, in Items 3.D.i and 3.E.i?

• Should the Commission require broker-dealers to identify in Items 3.D.iii and 3.E.iii the specific locations where free credit balances are held (*e.g.,* the names of banks and money market funds)?

D. Item 4—Carrying for Other Broker-Dealers

Item 4 of proposed Form Custody requires a broker-dealer to disclose whether it acts as a carrying broker-dealer for other broker-dealers. There are two sets of questions in Item 4—Item 4.A.i, ii, and iii and Item 4.B.i, ii, and iii. The first set of questions would elicit information from a broker-dealer as to whether it carries transactions for other broker-dealers on a fully disclosed basis. The second set of questions would elicit information from a broker-dealer as to whether it carries transactions for other broker-dealers on an omnibus basis.

Proposed Items 4.A.i and 4.B.i require a broker-dealer to indicate by checking the appropriate ''Yes'' or ''No'' box whether it carries customer accounts for another broker-dealer on a fully disclosed basis and on an omnibus basis, respectively. Items 4.A.ii and 4.B.ii require a broker-dealer, if applicable, to indicate the number of broker-dealers with which it has an arrangement to carry accounts on a fully disclosed basis and on an omnibus basis, respectively. Items 4.A.iii and 4.B.iii require a broker-dealer, if applicable, to identify any affiliated broker-dealers that introduce accounts to the broker-dealer on a fully disclosed basis and on an omnibus basis, respectively.

The Commission has stated that related person custody arrangements can present higher risks to ''advisory clients'' than maintaining assets with an independent custodian,[140] and the Commission believes the same to be true for broker-dealer clients. Consistent with the definition of the term in other contexts applicable to broker-dealers, including Form BD,[141] the General Instructions for proposed Form Custody would define the term ''affiliate'' as any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. The definition also would specify that ownership of 25% or more of the common stock of the broker-dealer introducing accounts to the broker-dealer submitting the Form Custody is deemed *prima facie* evidence of control; this definition is consistent with the definition used in Form BD.[142]

Item 4 in proposed Form Custody would elicit information about broker-dealers' custodial responsibilities with respect to accounts held for the benefit of *other* broker-dealers, and would require broker-dealers to identify such broker-dealers that are affiliates of the broker-dealer.[143] The Commission believes that this information will be useful for examination purposes and will provide the Commission with an enhanced understanding of, and useful and readily available information relating to, the scope of broker-dealer introducing/carrying relationships and activities, and the custodial practices of broker-dealers involved in such relationships.

The Commission generally requests comment on all aspects of proposed Item 4. In addition, the Commission requests comment on the following questions relating to proposed Item 4:

• The Commission is proposing to require that broker-dealers carrying accounts of other broker-dealers specify on proposed Form Custody the identities of only affiliated broker-dealers that introduce accounts to the carrying broker-dealer. Should the Commission require that broker-dealers carrying accounts of other, unaffiliated, broker-dealers specify on proposed Form Custody the identities of all broker-dealers that introduce accounts to the carrying broker-dealer?

• For purposes of defining the term ''affiliate'' in Item 4, should the Commission use the Form BD definition of the term ''affiliate''? Is there a more appropriate definition? If so, which definition? For example, should ownership by a carrying broker-dealer of 10% or more of the common stock of the introducing broker-dealer qualify such entities as affiliates?

E. Item 5—Trade Confirmations

Item 5 of proposed Form Custody would require broker-dealers to disclose whether they send transaction confirmations to customers and other accountholders by checking the appropriate ''Yes'' or ''No'' box. Confirmations are important safeguards that enable customers to monitor transactions that occur in their securities accounts. Timely confirmations would alert customers of unauthorized transactions and would provide customers with an opportunity to object to the transactions.

Exchange Act Rule 10b–10 specifies the information a broker-dealer must disclose to customers on a trade confirmation at or before completion of a securities transaction.[144] Generally, Rule 10b–10 requires a confirmation to include, among other things: (1) The date and time of the transaction and the identity, price, and number of shares or units (or principal amount) of such security purchased or sold by such customer; (2) the broker-dealer's capacity (agent or principal) and its compensation; (3) the source and amount of any third party remuneration it has received or will receive; and (4) other information, both general (*e.g.,* that the broker-dealer is not a SIPC member, if such is the case) and transaction-specific (*e.g.,* certain yield

[140] *See Custody of Funds or Securities by Investment Advisers,* Advisers Act Release No. 2968 (Dec. 30, 2009), 75 FR 1456 at 1462 (Jan. 11, 2010).

[141] Form BD is the uniform application for broker-dealer registration with the Commission. Form BD states that a person is presumed to control a company if, among other things, that person has directly or indirectly the right to vote 25% or more of a class of a voting security or has the power to sell or direct the sale of 25% or more of a class of voting securities, or, in the case of a partnership, the right to receive upon dissolution, or has contributed, 25% or more of the firm's capital.

[142] This definition of the term ''affiliate'' is the same as the definition in Form BD, including the specification that ownership of 25% or more of the common stock is deemed prima facie evidence of control.

[143] Form Custody would not require a broker-dealer to identify unaffiliated broker-dealers for which it carries accounts, though, as discussed above, it would need to indicate that it carries accounts for such broker-dealers. The Commission preliminarily believes that this approach provides the Commission and DEA examiners with access to useful information involving a broker-dealer's custody practices while alleviating potential time and cost burdens associated with completing proposed Form Custody given that some broker-dealers carry accounts for hundreds of unaffiliated broker-dealers. The Commission notes that information about these broker-dealers would be part of the books and records of the carrying broker-dealer. Therefore, an affirmative answer to Item 4 could prompt the Commission and DEA examiners to request information about the identities of the unaffiliated broker-dealers.

[144] 17 CFR 240.10b–10.

information in most transactions involving debt securities).

The information contained on a trade confirmation should reconcile with customer statements and the broker-dealer's journal entries.[145] In this regard, there is a direct link between trade confirmations sent by a broker-dealer and the broker-dealer's custody of customer assets.[146] How a broker-dealer answers Item 5 of proposed Form Custody could assist examiners in focusing their inspection. For example, if a broker-dealer claims that a third-party is responsible for sending trade confirmations, the examiners can confirm with that third-party that it is sending them on behalf of the broker-dealer.

The Commission generally requests comment on all aspects of proposed Item 5. In addition, the Commission requests comment on the following questions relating to proposed Item 5:

- If the broker-dealer answers ''No'' to Item 5.A, what information in addition to the identity of the broker-dealer that sends the confirmations would be useful to elicit in the form? For example, if the broker-dealer is a party to a carrying agreement pursuant to which a carrying broker-dealer agrees to issue trade confirmations for the broker-dealer, should the Commission require the broker-dealer to identify the date the agreement was made with the carrying broker-dealer and/or which SRO approved the carrying agreement?
- If the broker-dealer answers ''Yes'' to Item 5.A, and the broker-dealer has hired a third party service provider to prepare and send trade confirmations on the broker-dealer's behalf, should the broker-dealer be required to disclose the name of the third party service provider?
- Is there any additional information related to trade confirmations that the Commission should request in Item 5?

F. Item 6—Account Statements

Item 6 of proposed Form Custody would require broker-dealers to disclose whether they send account statements directly to customers and other accountholders by checking the appropriate ''Yes'' or ''No'' box. Account statements generally are sent to customers and other accountholders on a monthly or quarterly basis and typically set forth the assets held in the investor's securities account as of a specific date and the transactions that occurred in the account during the relevant period. SROs impose requirements on broker-dealers with respect to the statements they must send to their customers.[147] For example, FINRA generally requires any member that conducts a general securities business and also carries customer accounts or holds customer funds or securities, at least once each calendar quarter, to send an account statement to each customer whose account had a security position, money balance, or account activity since the last statement was sent.[148] The account statement must contain a description of any securities positions, money balances, or account activity in the account. In addition, the account statement must include a statement that advises the customer to report promptly any inaccuracy or discrepancy in that person's account to the brokerage firm.[149] The statement also is required to advise the customer that any oral communications made to the broker-dealer regarding inaccuracies or discrepancies should be re-confirmed in writing to further protect the customer's rights, including rights under SIPA.[150]

Like trade confirmations, account statements are important investor safeguards to monitor transactions that occur in an investor's securities account. As noted above, an introducing broker-dealer and clearing broker-dealer that are parties to a carrying agreement may allocate the sending of account statements to the clearing broker-dealer.[151] If the allocation has been made to a broker-dealer other than the broker-dealer completing Form Custody, this would be disclosed on the Form in Item 6.B. Item 6.C would elicit whether the broker-dealer sends account statements to anyone other than the beneficial owner of the account.[152]

The Commission is proposing to require broker-dealers to answer the questions in Item 6 to enhance its understanding of a broker-dealer's relationship with customers, particularly in the context of the broker-dealer's custodial responsibilities. The Commission notes that broker-dealers do not currently disclose to the Commission whether they send account statements directly to customers. Collecting this information on proposed Form Custody would provide examiners with additional background information that could be used to refine the focus of their inspections. Further, the Commission anticipates that examiners would make further inquiries to the extent the Form reveals answers that are inconsistent with industry practice.

A review of Item 6 also may facilitate an examiner's preparation for an inspection. For example, if a broker-dealer indicates on Form Custody that it holds customer accounts and sends account statements to customers, the examiner could prepare a more targeted document request to the broker-dealer. In this regard, an examiner could request customer account statements from the broker-dealer, as well as statements from the custodian(s) of the broker-dealer's customer assets, which would be disclosed in response to Item 3.C. of Form Custody. Examiners could then review and reconcile these documents to verify whether customer assets are held at the custodian(s) identified by the broker-dealer.

The Commission generally requests comment on all aspects of proposed Item 6. In addition, the Commission requests comment on the following questions relating to proposed Item 6:

[145] *See* 17 CFR 240.17a–3(a)(1), which requires the broker-dealer to make ''blotters'' ''(or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.''

[146] Although broker-dealers may allocate the function of sending confirmations to other broker-dealers or to service providers, the broker-dealer retains the responsibility for sending confirmations. *See New York Stock Exchange, Inc.; Order Approving Proposed Rule Change,* Exchange Act Release No. 18497 (Feb. 19, 1982), 47 FR 8284 (Feb. 25, 1982) at note 2 (''* * * no contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under the federal securities laws and applicable SRO rules'').

[147] *See* NASD Rule 2340 (Customer Account Statements) and NYSE Rule 409 (Statements of Accounts to Customers).

[148] *See* NASD Rule 2340, which defines a ''general securities member'' as any member that conducts a general securities business and is required to calculate its net capital pursuant to Rule 15c3–1. Additionally, NASD Rule 2340 defines ''account activity'' broadly so that it includes, but is not limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries and/or journal entries relating to securities or funds in the possession or control of the member. *See also* Exchange Act Release No. 54411 (Sept. 7, 2006), 71 FR 54105 (Sept. 13, 2006) (order granting approval of a proposed rule change relating to Rule 2340 concerning customer account statements).

[149] If the customer's account is serviced by both an introducing broker-dealer and a clearing broker-dealer, the statement must inform customers that such reports must be made to both firms. *See* NASD Rule 2340(a).

[150] *Id.*

[151] As with trade confirmations, broker-dealers can allocate the function but not the responsibility; *see supra* note 146.

[152] Generally, the beneficial owner of an account represents the person entitled to the economic benefits of ownership. With respect to securities, the term beneficial owner is defined in Rule 13d–3 under the Exchange Act (17 CFR 240.13d–3).

• If the broker-dealer answers ''No'' to Item 6.A, what information in addition to the identity of the broker-dealer that sends the account statements would be useful to elicit in the form?

• If a broker-dealer sends account statements to persons other than the beneficial owner of the account, should the Commission require the broker-dealer to explain why those persons receive account statements from the broker-dealer?

G. Item 7—Electronic Access To Account Information

Item 7 of proposed Form Custody would require broker-dealers to indicate whether they provide customers and other accountholders with electronic access to information about the securities and cash positions in their accounts by checking the appropriate ''Yes'' or ''No'' box. Electronic access to account information can provide investors with an efficient means of monitoring transactions that occur in their securities accounts. This inquiry would inform the Commission as to how readily customers are able to access and review their account information.

The Commission preliminarily believes that electronic access to account information is beneficial to customers, who can more easily monitor the performance of their accounts and perhaps more quickly identify any discrepancies or inaccuracies. The Commission proposes to include this item in proposed Form Custody because it would help to inform examiners as to how readily customers can access and review account information.

The Commission generally requests comment on all aspects of Item 7 to Form Custody. In addition, the Commission requests comment on the following questions related to Item 7:

• If a broker-dealer checks ''Yes'' in response to Item 7, should the Commission require additional disclosure on Form Custody relating to the types of electronic access the broker-dealer provides to customers and other accountholders?

• If a broker-dealer checks ''Yes'' in response to Item 7, should the Commission require broker-dealers to indicate on Form Custody if customers that elect to receive certain account-related communications (*e.g.,* trade confirmations) electronically also are sent copies of those documents via mail or whether they are limited to accessing those documents electronically?

H. Item 8—Broker-Dealers Registered as Investment Advisers

Item 8 of proposed Form Custody would elicit information, if applicable, about whether and how the broker-dealer operates as an investment adviser. The first question in proposed Item 8.A would require the broker-dealer to indicate whether it is registered as an investment adviser with the Commission under the Advisers Act or with one or more states pursuant to the laws of a state.[153] If the broker-dealer indicates that it is registered with the Commission under the Advisers Act or pursuant to state law (or both), then it would be required to respond to the remaining questions under proposed Item 8.

Proposed Item 8.B. would require the broker-dealer to disclose the number of clients it has as an investment adviser. This would provide the Commission with information about the scale of the broker-dealer's investment adviser activities.

Proposed Items 8.C would require the broker-dealer to complete a chart, which would consist of six columns, in which the broker-dealer would provide information about the custodians where the assets of the investment adviser clients are held.[154]

In the first column, the broker-dealer would be required to disclose the name of the custodian, and in the second column, the broker-dealer would be required to identify the custodian by either SEC file number or CRD number, as applicable.

The third and fourth columns of the chart would elicit information about the scope of the broker-dealer/investment adviser's authority over the accounts held at the custodian by requiring the broker-dealer/investment adviser to check the appropriate ''Yes'' or ''No'' box. Specifically, in the third column, the broker-dealer/investment adviser would indicate whether it has the authority to effect transactions in the advisory client accounts at the custodian. In the fourth column, the broker-dealer/investment adviser would indicate whether it has the authority to withdraw funds and securities out of the accounts at the custodian.

In the fifth column, the broker-dealer/investment adviser would indicate whether the custodian sends account statements directly to the investment adviser clients. The Commission recently adopted amendments to the IA Custody Rule to require that investment advisers have a reasonable basis, after due inquiry, for believing that qualified custodians of advisory client assets send account statements to the investment advisers' clients. As stated in the release adopting that requirement, the Commission believes that the direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients.[155]

In the sixth column, the broker-dealer/investment adviser would indicate whether investment adviser client assets are recorded on the broker-dealer's stock record. If the broker-dealer is acting as custodian for such assets, the Commission anticipates that those assets would be recorded on the stock record.

The information solicited in Item 8 differs from the information that would be elicited in Item 3, because Item 3 requires a broker-dealer to provide detailed information about its custodial functions. In contrast, the goal of the information elicited in Item 8 is to assist the Commission and DEA examiners in developing a profile of the firm with respect to its functions as an investment adviser, and not as a custodian.

The Commission generally requests comment on all aspects of proposed Item 8. In addition, the Commission requests comment on the following questions:

• Should the Commission request additional information from dually-registered broker-dealer/investment

[153] Section 203A of the Advisers Act prohibits certain investment advisers from registering with the Commission, based on the advisers' assets under management, among other factors.

[154] Under the IA Custody Rule, it is a ''fraudulent, deceptive, or manipulative act, practice or course of business'' for an investment adviser registered or required to be registered under Section 203 of the Advisers Act to have custody of client funds or securities unless, among other things, a qualified custodian maintains those funds or securities. *See* Rule 206(4)–2. The Commission defines a qualified custodian as: (1) A bank as defined in Section 202(a)(2) of the Advisers Act or savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (2 U.S.C. 1811); (2) a broker-dealer registered under Section 15(b)(1) of the Exchange Act holding the client assets in customer accounts; (3) an FCM registered under Section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (4) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. *See* Rule 206(4)–2(d)(6). The Commission requires that the qualified custodian maintain client funds and securities: (1) In a separate account for each client under that client's name; or (2) in accounts that contain only the clients' funds and securities, under the investment adviser's name as agent or trustee for the clients. *See* Rule 206(4)–2(a)(1).

[155] *See, e.g., Custody of Funds or Securities by Investment Advisers,* Advisers Act Release No. 2876 (May 20, 2009), 74 FR 25354 (May 27, 2009) (proposing release); Advisers Act Release No. 2968 (Dec. 30, 2009), 75 FR 1456 (Jan. 11, 2010) (adopting release).

advisers in the chart located in Item 8.C? If so, what information should the Commission request?

• Should the Commission require broker-dealer/investment advisers to disclose the type of client assets held by custodians (*e.g.,* fixed income securities or equity securities, *etc.*)?

• Should the Commission amend the charts in Item 8 to require broker-dealer/investment advisers to disclose the dollar amount of assets held at the custodian in ranges?

I. Item 9—Broker-Dealers Affiliated with Investment Advisers

Item 9 of Form Custody would elicit information concerning whether the broker-dealer is an affiliate of an investment adviser. For these purposes, an affiliate is any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. Ownership of 25% or more of the common stock of the investment adviser is deemed *prima facie* evidence of control.[156] If the broker-dealer is such an affiliate, Item 9 would also elicit information concerning whether the broker-dealer has custody of client assets of an affiliated investment advisor and, if so, the approximate U.S. dollar market value of the assets.

The Commission generally requests comment on all aspects of proposed Item 9. In addition, the Commission requests comment on the following question related to Item 9:

• Should the Commission define affiliate differently? Should the Commission use a different percentage of ownership for *prima facie* evidence of control?

J. Proposed Text Amendments To Require the Filing of Form Custody

The Commission is proposing to add a new paragraph (a)(5) to Rule 17a-5 to implement the Form Custody filing requirement. Specifically, proposed paragraph (a)(5) would provide that ''[e]very broker or dealer subject to this paragraph (a) shall file Form Custody with its designated examining authority within 17 business days after the end of each calendar quarter and within 17 business days after the date selected for the annual reports where said date is other than the end of a calendar quarter. The designated examining authority shall maintain the information obtained through the filing of the Form Custody and transmit such information to the Commission.'' [157] The proposed language, including filing proposed Form Custody within 17 business days after the end of each calendar quarter, is the same as the existing requirements under Rule 17a-5 pertaining to the time frame for broker-dealers to file their FOCUS Reports,[158] and the maintenance of the FOCUS Reports filed with the DEAs.[159]

The Commission generally requests comment on all aspects of proposed new paragraph (a)(5) of Rule 17a–5. In addition, the Commission requests comment on the following question related to proposed new paragraph (a)(5):

• Should the Commission require the proposed Form Custody be filed on a different schedule? If so, what schedule?

K. General Solicitation of Comments on Form Custody

In addition to the questions above with respect to the specific Items of Form Custody, the Commission requests comment more generally on the overall approach of the proposal. In addition, the Commission requests comment on the following questions:

• Should the Commission require that the broker-dealer engage an independent public accountant with respect to Form Custody? If so, what level of engagement should be required? For example, should the Form Custody be audited by the independent public accountant?

V. Additional Amendments to Rule 17a–5

In addition to the proposed amendments discussed above and their corresponding technical amendments, the Commission proposes several ''clean up'' amendments to Rule 17a-5 that would modernize the rule and delete unnecessary or outdated provisions.

A. Requirement To File Annual Reports

The Commission proposes to amend paragraph (d)(6) of Rule 17a–5 to provide that copies of the annual reports shall be provided to all SROs of which the broker-dealer is a member ''unless the self-regulatory organization by rule waives this requirement.'' The Commission proposes this addition because in some cases SROs do not believe it is necessary to receive copies of broker-dealer annual reports, particularly when they are not the broker-dealer's DEA.

The Commission also proposes to amend paragraph (d)(6) of Rule 17a–5 to require broker-dealers to file copies of their annual reports with SIPC. As discussed above, SIPC may be required to fund the liquidation of a broker-dealer that cannot wind itself down in an orderly fashion. As part of the liquidation process, SIPC may be required to advance up to $500,000 per customer to satisfy claims for cash and securities of which $250,000 can be used to satisfy claims for cash.[160] In order to pay for these liquidations and advances, SIPC maintains the SIPC Fund. This SIPC Fund is established and maintained by collecting assessments from broker-dealers that are required to be members of SIPC.[161]

In some cases where SIPC has used the SIPC Fund to liquidate failed broker-dealers and make advances to customers, SIPC has not been able to recover the money advanced because the estate of the failed broker-dealer had insufficient assets.[162] SIPC has sought to recover money damages from auditing firms, but at least one court has held under New York law that SIPC could not maintain a claim because it was not a recipient of the annual audit filing and could not have relied on it.[163] Therefore, if SIPC had received a copy of the annual reports as contemplated under this proposed amendment, SIPC could have brought a claim against the auditing firm. In addition, the filing of annual reports with SIPC could allow it to better monitor industry trends and enhance its knowledge of particular firms.

The Commission generally requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following question related to the proposal:

• Rather than filing the annual reports directly with SIPC, should the Commission propose that the broker-dealers make the reports available to SIPC upon request? If so, why? If no, why not?

B. Confidentiality of Annual Reports

The Commission also proposes to update the method in which broker-

[156] *See supra* note 141 and corresponding text which specifies the same ownership percentage on Form BD.

[157] *See* proposed paragraph (a)(5) of Rule 17a-5. The Commission proposes to amend the numbering of the remaining subparagraphs—for example, current paragraph (a)(5) of Rule 17a-5 would be renumbered as paragraph (a)(6) and current paragraph (a)(6) would be renumbered as paragraph (a)(7).

[158] *See* Rule 17a–5(a)(2)(ii).

[159] *See* Rule 17a–5(a)(4).

[160] 15 U.S.C. 78fff–3(a), (d).

[161] 15 U.S.C. 78ddd.

[162] The most recent example of a SIPA liquidation in which SIPC does not expect to recover money advanced to a trustee is the liquidation of Bernard L. Madoff Investment Securities LLC. *SIPC 2010 Annual Report,* p.18, available at *http://www.sipc.org/pdf/2010%20Annual%20Report.pdf.*

[163] *See SIPC* v. *BDO Seidman, LLP,* 746 N.E.2d 1042 (N.Y. 2001).

dealers request that their annual reports be filed with the Commission on a confidential basis. Currently, under paragraph (e)(3) of Rule 17a–5, in order for a broker-dealer to receive confidential treatment for the financial statements it files with the Commission, other than the Statement of Financial Condition, the broker-dealer must bind the Statement of Financial Condition separately from the remaining financial statements and denote the Statement of Financial Condition as ''Public'' and the separate document as ''Confidential.''[164] The wording of this provision has led to confusion, resulting in inquiries to the Commission staff on how broker-dealers can receive confidential treatment for financial statements filed with the Commission under paragraph (e)(3) of Rule 17a–5, and, on occasion, broker-dealers inadvertently making publicly available financial statements intended to be confidential. The Commission proposes that broker-dealers continue to bind separately the Statement of Financial Condition from the remaining pages of the annual reports. In order to provide better clarity as to which part of the annual report is public and which part should be kept confidential, the Commission proposes to require that the broker-dealer stamp each page of the separately bound confidential portion of its annual reports as ''Confidential.''

Paragraph (e)(3) of Rule 17a–5 currently provides that the annual reports, including the confidential portions, shall be available, for example, for official use by any official or employee of the U.S., and national securities exchanges and registered national securities associations of which the person filing is a member. The Commission proposes to amend paragraph (e)(3) of Rule 17a–5 to include the PCAOB as a permitted recipient. The Commission further proposes to amend paragraph (e)(3) of Rule 17a–5 by updating references to the revised rule and reflecting the proposed Annual Audit Reports.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following question related to the proposal:

- Would this proposed amendment be the simplest method to request confidentiality treatment, or is there a better alternative?

C. Removing Obsolete Provisions

The Commission proposes to delete paragraph (e)(5) of Rule 17a–5 in its entirety because the provisions are now moot. Paragraph (e)(5) of Rule 17a–5 discusses the requirement for broker-dealers to file Form BD–Y2K. Form BD–Y2K elicited information with respect to the broker-dealer's readiness for the year 2000 and any potential problems that could arise with the advent of the new millennium.[165] Form BD–Y2K was required to be filed in April of 1999 and only then.

D. Classification of Qualified Accountant

The Commission proposes to amend paragraph (f)(1) of Rule 17a–5, which determines how the Commission classifies a qualified independent public accountant, by adding a sentence to the paragraph stating that the ''accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.'' This is a technical, non-substantive amendment because broker-dealer accountants are already required to be registered with the PCAOB.

E. Technical Amendments

The Commission proposes to delete paragraph (b)(6) of Rule 17a–5, which currently provides that a ''copy of the annual audit report shall be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business and the principal office of the designated examining authority for said broker or dealer. Two copies of said report shall be filed at the Commission's principal office in Washington, DC. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member.'' The Commission proposes to delete this paragraph because it is redundant to the requirement in paragraph (d)(6) of the rule.[166]

For consistency purposes, the Commission proposes to delete references to ''balance sheet'' and replace them with references to ''Statement of Financial Condition.''[167]

The Commission also proposes technical amendments to paragraph (e)(1)(i) of Rule 17a–5. Paragraph (e)(1)(i) provides the exemption for broker-dealers that are not required to engage an independent public accountant to audit their financial statements. The technical amendments that the Commission is proposing include updating references and clarifying the existing language.[168] The Commission also proposes technical amendments to paragraph (e)(1)(ii) of Rule 17a–5, which requires a broker-dealer to include an oath or affirmation related to the claimed exemption from the annual audit requirement. Specifically, the Commission proposes to update references and other non-substantive changes to the text of the paragraph.

Further, the Commission is proposing to amend paragraph (e)(4)(iii)(F) of Rule 17a–5 to correct an inaccurate reference to a form filed in connection with the SIPC Reports. Currently, paragraph (e)(4)(iii)(F) refers to the ''Certificate of Exclusion from Membership'' as Form SIPC–7. The proposed amendments would change the reference in proposed paragraph (e)(4)(iii)(F) from Form SIPC–7 to Form SIPC–3 in proposed paragraph (e)(4)(ii)(C).

In addition, the Commission is proposing to amend paragraphs (f)(1) and (f)(3) of Rule 17a–5. Currently, paragraph (f)(1) of Rule 17a–5 contains the ''Qualification of accountants.'' Specifically, paragraph (f)(1) states that the ''Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of his place of residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of his place of residence or principal office.''[169] Paragraph (f)(3) of Rule 17a–5 contains the requirement for independence: ''[a]n accountant shall be independent in accordance with the provisions of § 210.2–01(b) and (c) of

[164] The Commission's Web site provides guidance that the public and non-public portions of the financial statements must be clearly segregated and the Facing Page must be appropriately marked. For example, the Facing Page attached to the Statement of Financial Condition should not be marked ''Confidential.'' Further, if the Statement of Financial Condition is not bound separately or placed in a separate package, then, in accordance with Rule 17a–5(e)(3), none of the statements will be accorded confidential treatment. *See* ''Broker-Dealer Notices and Reports'' at *http://www.sec.gov/divisions/marketreg/bdnotices.htm.*

[165] *See Reports to be Made by Certain Brokers and Dealers,* Exchange Act Release No. 40608 (Oct. 28, 1998), 63 FR 59208 (Nov. 3,1998).

[166] As previously discussed, the Commission proposes to amend paragraph (d)(6) of Rule 17a–5 to require that a copy of the annual report be filed with SIPC. Specifically, the Commission proposes that paragraph (d)(6) provide that the annual reports shall ''be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, and the principal office of the designated examining authority for said broker or dealer and with the Securities Investor Protection Corporation. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement.''

[167] *See, e.g.,* Rule 17a–5(c)(2)(i).

[168] *See, e.g.,* proposed Rule 17a–5(e)(1).

[169] *See* Rule 17a–5(f)(1).

this chapter.'' The Commission proposes to delete paragraph (f)(3) and amend (f)(1) to state that ''the independent public accountant must be qualified and independent in accordance with § 210.2–01 of this chapter. In addition, the accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.'' The Commission is proposing this technical amendment to update the definition of an independent public accountant to be consistent with other Commission rules. Furthermore, by citing to § 210.2–01 in its entirety, rather than the provisions of (b) and (c), the text of (f)(1) becomes unnecessary. The Commission is also proposing a conforming amendment to paragraph (f)(4), which contains a notice provision concerning the replacement of the broker-dealer's independent public accountant. Paragraph (f)(4) would be renumbered as (f)(3).

The Commission is proposing to delete paragraph (i)(5) of Rule 17a–5, which provides that the terms ''audit,'' ''accountant's report,'' and ''certified'' ''shall have the meanings given in § 210.1–02 of this chapter.'' The Commission is proposing to delete this paragraph because the terms are defined under existing auditing standards promulgated by the PCAOB.

The Commission is proposing additional technical amendments throughout Rule 17a–5, including changes to consistently use the defined term ''independent public accountant'' [170] and to make the rule gender neutral.[171]

- The Commission generally requests comment on all aspects of the amendments proposed in this Section V.

VI. Paperwork Reduction Act

The proposed amendments to Rule 17a–5 contain a ''collection of information'' within the meaning of the Paperwork Reduction Act of 1995 (''PRA''). The Commission is submitting the proposed amendments and the proposed new collection to the Office of Management and Budget (''OMB'') for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid control number. The titles for the collections of information are:

(1) Rule 17a–5, Reports to be made by certain brokers and dealers (OMB Control Number 3235–0123);

(2) Rule 17a–11, Notification provisions for brokers and dealers (OMB Control Number 3235–0085); and

(3) Form Custody (a proposed new collection of information).

A. Collections of Information Under the Proposed Rule Amendments

As discussed above, the Commission is proposing three sets of amendments to Rule 17a–5. The first set of proposed amendments, the Annual Reporting Amendments, would: (1) Update the existing requirements of the rule; (2) facilitate the PCAOB with its inspection and oversight authority over broker-dealer independent public accountants; and (3) enable a broker-dealer to use a single report to satisfy the proposed requirements under Rule 17a–5 and the IA Custody Rule's internal control report requirement.

The second set of proposed amendments, the Access to Audit Documentation Amendments, applies only to clearing broker-dealers. The Access to Audit Documentation Amendments are designed to facilitate the communication between a clearing broker-dealer's independent public accountant and representatives of Commission and the DEA. Additionally, the Access to Audit Documentation Amendments are designed to enable representatives of the Commission and the DEA of the clearing broker-dealer, in the scope of their examination of the firm, to have access to the audit documentation related to the examination of the broker-dealer.

The third set of proposed amendments, the Form Custody Amendments, would enhance the information received by the Commission and DEAs with respect to the custody practices of broker-dealers by requiring broker-dealers to file on a quarterly basis a new Form Custody. Proposed Form Custody would elicit information as to whether and how a broker-dealer maintains custody of cash and securities of customers and others.

Each set of proposed amendments has a corresponding paperwork burden, which is addressed below.

B. Proposed Use of Information

As discussed above, the Commission is proposing three sets of amendments to Rule 17a–5. The first set of proposed amendments, the Annual Reporting Amendments, would require a broker-dealer to either file a Compliance Report or an Exemption Report as part of its annual audit requirements under Rule 17a–5. The Compliance Report would be filed by a carrying broker-dealer and contain assertions by the broker-dealer with respect to the Financial Responsibility Rules. The Exemption Report would be filed by a broker-dealer that claims an exemption from Rule 15c3–3 because it does not operate as a carrying broker-dealer and would contain an assertion as to the basis for the claimed exemption. In addition, the broker-dealer would be required to engage an independent public accountant to provide a report addressing the accuracy of the assertions in either the Compliance Report or Exemption Report, as applicable.

The Commission preliminarily believes that the information gathered from the proposed Annual Reporting Amendments would assist the PCAOB in establishing an effective oversight and inspection program over the independent public accountants of broker-dealers, and it would enable broker-dealers that are jointly registered as investment advisers to use a single report to satisfy the proposed requirements under Rule 17a–5 and the IA Custody Rule's internal control report requirement.

The second set of proposed amendments, the Access to Audit Documentation Amendments, would provide the Commission and DEA examiners with access to clearing broker-dealer independent public accountants to discuss the independent public accountants' findings with respect to broker-dealer annual audit reports and to review audit documentation associated with those reports. Specifically, the amendments would require a representation from the clearing broker-dealer that it agrees to permit its independent public accountant to discuss with representatives of the Commission the findings with respect to annual audit reports of broker-dealers and review the related audit documentation. These proposed amendments would provide another tool to Commission and DEA examiners of broker-dealers by providing access to additional relevant information.

The third set of proposed amendments, the Form Custody Amendments, would establish a new Form Custody that the broker-dealer would need to include when filing its quarterly FOCUS Reports. Form Custody would elicit information as to whether and how a broker-dealer maintains custody of cash and securities of customers and others. The Commission preliminarily believes that proposed Form Custody would provide more detailed information about a broker-dealer's custodial activities. Moreover, proposed Form Custody could assist in expediting the

[170] *See, e.g.,* proposed paragraph (f)(4) of Rule 17a–5.

[171] *Id.*

Commission's or DEA's examination of a broker-dealer's custodial activities as examiners would no longer need to request basic custody-related information already disclosed on the form.

C. Respondents

The applicability of the proposed amendments discussed in this release depends on how a broker-dealer conducts its business. There are 5,063 broker-dealers registered with the Commission as of year-end 2009. Of the 5,063 registered broker-dealers, 305 broker-dealers are carrying broker-dealers—*i.e.,* broker-dealers that maintain custody of customer funds and/or securities and are required to comply with the customer protection provisions of Rule 15c3–3. The type of report a broker-dealer would be required to file under the proposed Annual Reporting Amendments would be based on whether a broker-dealer is a carrying broker-dealer subject to Rule 15c3–3, or is exempt from Rule 15c3–3. Carrying broker-dealers would be required to file Compliance Reports under the proposed Annual Reporting Amendments. Broker-dealers exempt from Rule 15c3–3 would be required to file Exemption Reports. There are 4,752 broker-dealers that claim exemptions to Rule 15c3–3.[172] The Commission estimates 305 carrying broker-dealer respondents would file the proposed Compliance Report and 4,752 non-carrying broker-dealer respondents would file the proposed Exemption Report under the Annual Reporting Amendments.[173]

The Access to Audit Documentation Amendments would apply to clearing broker-dealers, which, as defined above, includes broker-dealers that clear transactions or carry customer accounts. There are 528 clearing broker-dealers based on year-end 2009 FOCUS Report data, and, accordingly, the Commission estimates that there would be 528 broker-dealer respondents with respect to the Access to Audit Documentation Amendments.[174]

The Commission estimates that there would be approximately 5,057 broker-dealer respondents with respect to the Form Custody Amendments.[175]

Additionally, the Commission estimates that there could be approximately 550 independent public accountants affected by the amendments. This number represents the number of independent public accountants registered with the PCAOB that are engaged to perform broker-dealer audits.

The Commission generally requests comment on all aspects of these estimates. In addition, the Commission requests specific comment on the following items related to these estimates:

- Should the Commission use different estimates for the number of respondents for the Annual Reporting Amendments? If so, what estimates should the Commission use and why? What are the sources of these estimates?
- Should the Commission use different estimates for the number of broker-dealer respondents for the Access to Audit Documentation Amendments? If so, what estimates should the Commission use and why? What are the sources of these estimates?
- Should the Commission use a different estimate of the number of independent public accountants that would be affected by the amendments? If so, what estimate should the Commission use and why? What is the source of this estimate?

Commenters should provide specific data and analysis to support any comments they submit with respect to these estimates with respect to the number of respondents.

D. Total Annual Recordkeeping and Reporting Burden

As discussed below, the Commission estimates the total recordkeeping burden resulting from the proposed Rule 17a–5 amendments would be approximately 287,325 hours on an annual basis[176] and 10,214 hours on a one-time basis.[177] The Commission notes that, given the significant variance between the largest broker-dealer and the smallest broker-dealer, the total annual and one-time hour burden estimates described below are averages across all types of broker-dealers expected to be affected by the proposed amendments.

1. Annual Reporting Amendments

a. Financial Reports Filed With the Commission

Currently, broker-dealers are required to file their annual audit report, which, as discussed previously, the Commission proposes to rename as the broker-dealer's ''Financial report'' in Rule 17a–5. The Commission is not proposing any substantive changes to the financial audit; therefore the Commission believes the hour burden for broker-dealers with respect to financial reports would remain the same.[178] As is discussed in Section V.E. of this release, the Commission is proposing to delete paragraph (b)(6) of Rule 17a–5, which currently provides that two copies of a broker-dealer's annual audit report be filed at the Commission's principal office in Washington, DC, because it is redundant with paragraph (d)(6) of Rule 17a–5, which requires that only one copy of a broker-dealer's annual audit report be filed at the Commission's principal office in Washington, DC. By deleting paragraph (b)(6) of Rule 17a–5, only one copy of the annual audit report would need to be filed with the Commission, rather than two, which will result in a slight reduction in broker-dealers' hour burden in providing related papers to the Commission.[179]

The Commission requests comment on all aspects of these proposed burden estimates. Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates, if possible.

b. Compliance Report and Examination Report

The Commission proposes to require carrying broker-dealers to file two new reports: (1) The proposed Compliance Report, which is prepared by the carrying broker-dealer; and (2) the Examination Report, which is prepared by the broker-dealer's independent public accountant as a result of its examination of the Compliance

[172] These numbers are based on FOCUS Report data as of year-end 2009. *See supra* note 126 for a description of the FOCUS Report. As discussed in note 126, FOCUS Reports are deemed to be confidential pursuant to paragraph (a)(3) of Rule 17a–5.

[173] There are 4,752 broker-dealers that claim an exemption to Rule 15c3–3.

[174] The clearing broker-dealers would be required to respond to the paperwork burdens associated with the Access to Audit Documentation Amendments, and 528 broker-dealers represent the number of Part II FOCUS filers.

[175] Carrying broker-dealers and non-carrying broker-dealers would be required to file Form Custody; 305 + 4,752 = 5,057.

[176] The total annual hour burden is estimated to be 287,325 hours (18,300 hours for the Compliance Report + 23,760 hours for the Exemption Report + 2,529 hours for copies of the Annual Reports to be filed with SIPC + 242,736 hours for Form Custody).

[177] The total one-time burden is estimated to be 10,114 hours for the revised Notice Designating Accountant (required for the proposed Access to Audit Documentation Amendments) + 100 hours for SIPC forms to be filed with respect to the SIPC proposal.

[178] The Commission notes that the financial audit would be subject to standards promulgated by the PCAOB; however, this would not change the Commission's prescribed reporting burden associated with the financial audit.

[179] As is discussed above in Section V.A. of this release, broker-dealers would be required to file a copy of their annual audit reports with SIPC under proposed paragraph (d)(6) of Rule 17a–5, which would impose an annual hour burden on broker-dealers. This burden is discussed below in Section VI.D.1.d of this release.

Report.[180] Included in the Compliance Report would be a statement that the carrying broker-dealer is responsible for establishing and maintaining a system of internal control to provide the broker-dealer's management with reasonable assurance that there are no instances of material non-compliance with the Financial Responsibility Rules and three assertions. The three assertions would be whether the broker-dealer: (1) Was in compliance with Financial Responsibility Rules as of its most recent fiscal year-end; (2) used information derived, in all periods during the fiscal year, from the broker-dealer's books and records; and (3) had a system of internal control over compliance with these rules that was effective during the most recent fiscal year such that there were no instances of material weakness.

The Commission preliminarily believes that broker-dealers would validate, gather, and review records to enable them to make the assertions in the proposed Compliance Report. The Commission estimates, on average, that broker-dealers would spend an additional 60 hours to perform the validation and evidence gathering.[181] For all carrying broker-dealers, we estimate the annual hour burden to be 18,300 hours.[182]

The Commission requests comment on all aspects of these proposed burden estimates. Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates, if possible.

c. Exemption Report

For a non-carrying broker-dealer claiming an exemption from Rule 15c3–3, the proposed Exemption Report would require the broker-dealer to assert that it is exempt from Rule 15c3–3 and identify the provision of the rule that it is relying on to qualify for the exemption. The non-carrying broker-dealer would be required to include this assertion in its Exemption Report to be filed with the Commission. The Commission does not anticipate that this requirement will result in a significant hourly burden because the broker-dealer has been operating under the claimed exemption and is aware of what exemption it will claim on the Exemption Report. Therefore, the hour burden associated with this proposed amendment should be administrative and encompass the drafting and filing of the report. Based on staff experience with broker-dealers filing similar types of reports, the Commission estimates it should take a non-carrying broker-dealer five hours to prepare the Exemption Report and file the Exemption Report and copy of the associated independent public accountant's report with the Commission and applicable securities regulators. Thus, we estimate the annual hour burden for broker-dealers required to file the Exemption Report and associated independent public accountant's report would be 23,760 hours.[183]

The Commission requests comment on all aspects of these proposed burden estimates. Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates, if possible.

d. Copies of Annual Reports Filed With SIPC

The Commission is proposing that copies of broker-dealer annual reports (including the Financial Report and either the Compliance Report and corresponding independent public accountant's report based on the Compliance Examination, or the Exemption Report and corresponding independent public accountant's report based on the review of the Exemption Report) be filed with SIPC. The Commission estimates that broker-dealers would incur an administrative cost associated with the additional filing. The Commission estimates that it would take 30 minutes to prepare the additional copies and mail them to SIPC. Therefore, the Commission estimates that there is an annual hour burden of 2,529 with respect to this requirement.[184]

The Commission requests comment on all aspects of these proposed burden estimates. Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates, if possible.

e. Notice of Designated Accountant

The Commission proposes amending Rule 17a–5(f)(2) and the Notice of Designated Accountant. As discussed above, the Commission proposes to require broker-dealers to state in their Notice that they have engaged an independent public accountant pursuant to proposed paragraph (g) of Rule 17a–5. Broker-dealers are currently required to file a Notice with the Commission designating the independent public accountant who will be conducting the broker-dealer's annual audit.

The Commission proposes to require that broker-dealers file a revised Notice designating their independent public accountant and containing the proposed new provisions in subparagraphs (D) through (G) to Rule 17a–5(f)(2)(ii), as applicable. As previously discussed, proposed new subparagraph (D) requires the broker-dealer to indicate whether the engagement is for a single year or not. Proposed subparagraph (E) requires the broker-dealer to make a representation that the engagement of the independent public accountant by the broker or dealer meets the required undertakings of paragraph (g).[185] Each clearing broker-dealer is required to make the following representations: (1) That it agrees to allow representatives of the Commission or its DEA, if requested for purposes of an examination of the broker-dealer, to review the audit documentation associated with the reports of the independent public accountant prepared pursuant to paragraph (g) of Rule 17a–5;[186] and (2) to permit the independent public accountant to discuss with representatives of the Commission and the DEA of the broker-dealer, if requested for purposes of an examination of the broker-dealer, the findings associated with the reports of the independent public accountant prepared pursuant to paragraph (g) of Rule 17a–5.[187]

The Commission notes that broker-dealers have previous versions of the Notice containing the current required information that could be used and revised to include the proposed new information. Therefore, the Commission estimates that it would take a broker-dealer approximately two hours to amend its existing Notice and file its new Notice pursuant to the proposed amendments. This estimate includes the time it would take a compliance officer and potentially other personnel to review the revised Notice to ensure that it complies with the proposed

[180] The Compliance Report and Examination Report are discussed in Section II.B.2 of this release.

[181] The Commission's preliminary estimate of 60 hours is an average based on the varying sizes of carrying broker-dealers and is based on staff experience.

[182] 60 hours × 305 carrying broker-dealers = 18,300. *See infra* Economic Analysis Section for a discussion of the external cost estimates associated with the independent public accountant preparing the Examination Report based on an examination of the Compliance Report.

[183] 5 hours × 4,752 non-carrying broker-dealers = 23,760 hours. *See infra* Economic Analysis Section for a discussion of the external costs associated with engaging an independent public accountant to prepare its report based on the review of the broker-dealer's Exemption Report.

[184] 1/2 hour × 5,057 broker-dealers = 2,528.50 hours, which is rounded up to 2,529 hours.

[185] *See* proposed paragraph (f)(2)(ii)(E) of Rule 17a–5.

[186] *See* proposed paragraph (f)(2)(ii)(F) of Rule 17a–5.

[187] *See* proposed paragraph (f)(2)(ii)(G) of Rule 17a–5.

requirements. The Commission notes that the Notice can be continuing in nature and therefore the designation of an independent public accountant can apply to successive audits. Thus, the Commission estimates that the filing of the proposed new Notice would result in a one-time burden for broker-dealers. The Commission further estimates that this would be a one-time hour burden associated with revising and filing the new Notice, which would total 10,114 hours for all broker-dealers.[188]

The Commission requests comment on all aspects of these proposed burden estimates. If possible, commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

f. SIPC Forms

As previously discussed, the Commission proposes to amend Rule 17a–5 to provide that broker-dealers continue to file their required SIPC Forms with the Commission and SIPC unless the Commission takes final action to approve any proposed rule change SIPC may file for Commission consideration to require the filing of the forms solely with SIPC. Because broker-dealers are currently required to file the forms with both the Commission and SIPC, the Commission does not believe there is any change in the hour burden for broker-dealers to comply with this requirement.

However, the Commission notes that SIPC would have to file a proposed and final rule with the Commission, to, as discussed above, require broker-dealers to file the SIPC Forms with SIPC. Based on staff experience with filings related to SRO rule changes, the Commission estimates that it would take, conservatively, 100 hours for SIPC to prepare the filings necessary to require broker-dealers to file the SIPC Forms solely with SIPC. Therefore, the one-time hour burden associated with this requirement is 100 hours. Additionally, the Commission notes that subsequent to the adoption of SIPC's rule, that broker-dealers would benefit from only having to file the reports with one entity.

The Commission requests comment on all aspects of these proposed burden estimates. Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates, if possible.

2. Access to Audit Documentation Amendment

The Commission proposes to amend Rule 17a–5 to require broker-dealers to consent to allow representatives of the Commission and DEA to speak with, and review the audit documentation of, their independent public accountants, if requested in connection with a regulatory examination. As previously discussed, the rule proposal would require broker-dealers to amend and file a new Notice. As described above, the Commission calculated the hour burden associated with amending the Notice with respect to the proposed Annual Reporting. The Commission believes the estimated hour burden includes, if applicable, the needed representations associated with the Access to Audit Documentation.

The Commission requests comment on all aspects of these proposed burden estimates. Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates, if possible.

3. Proposed Form Custody

The Commission is proposing a new form—Form Custody—that is designed to elicit information about whether and how a broker-dealer maintains custody of customer assets and handles customer cash. As discussed below, a broker-dealer would be required to file Form Custody quarterly and with its annual audit reports. The goal is to create a report that provides information about the custodial activities of broker-dealers that can serve as a starting point for securities regulators to undertake more in depth reviews as they deem appropriate.

As discussed above, the proposed form is comprised of nine line items that elicit information about the broker-dealer's custodial responsibilities and operations. Some of the items contain multiple questions and also require the completion of charts or the disclosure of additional data points in designated spaces on the form.

The Commission preliminarily believes that the hour burden associated with the FOCUS Report provides an appropriate baseline for estimating the hour burden associated with the proposed Form Custody because the FOCUS Report is a broker-dealer report that requires the broker-dealer to provide financial and operational information.[189] Specifically, the Commission believes that the information the broker-dealer uses to compute the required computation related to Rule 15c3–3 in the FOCUS Report can be used in answering the questions contained in the proposed Form Custody. Thus, the Commission bases this estimate on the current hour burden estimate for broker-dealers to complete their FOCUS Reports, and that on average, each broker-dealer would require 12 hours to complete Form Custody.[190] This results in an estimated annual burden of 242,736 hours.[191]

The Commission requests comment on all aspects of these proposed burden estimates. Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates, if possible.

4. Technical Amendments to Rule 17a–5 and to Rule 17a–11

The Commission believes that the proposed technical amendments to Rule 17a–5 (*e.g.,* making the rule gender-neutral)[192] would not impose any additional time burden on broker-dealers. Additionally, the Commission's proposed conforming amendment to paragraph (e) of Rule 17a–11 (eliminating a reference to current paragraph (h) of Rule 17a–5 and correcting references) is also technical in nature and should not result in an additional hour burden.

E. Collection of Information Is Mandatory

The collection of information obligations imposed by the proposed rule amendments and the proposed new rule would be mandatory for broker-dealers that are registered with the Commission.

F. Confidentiality

The Commission notes that a broker-dealer can seek confidential treatment for information filed with the Commission under existing laws and rules governing confidential treatment.[193] The Commission will accord this information confidential treatment to the extent permitted by law.[194]

[188] 2 hours × 5,057 broker-dealers = 10,114.

[189] *See supra* note 126.

[190] The Commission notes that the current PRA hour burden estimate for the FOCUS Report filing is 12 hours. *See* SEC File No. 270–155, 75 FR 8759 (Feb. 25, 2010).

[191] 5,057 × 4 = 20,228 annual responses × 12 hours = 242,736.

[192] *See supra* discussion in Section V. E. for specified technical amendments.

[193] 15 U.S.C. 78o–7(k). A broker-dealer can request that the Commission keep this information confidential. *See* Section 24 of the Exchange Act (15 U.S.C. 78x), 17 CFR 240.24b–2, 17 CFR 200.80 and 17 CFR 200.83.

[194] To the extent that the Commission receives confidential information pursuant to this collection of information, such information would be kept

Continued

G. Request for Comment

Pursuant to 44 U.S.C. 3306(c)(2)(B), the Commission requests comment on the proposed collections of information in order to: (1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and (5) evaluate whether the proposed rule amendments would have any effects on any other collection of information not previously identified in this section.

Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090, and refer to File No. S7–23–11. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the **Federal Register**; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–23–11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE., Washington, DC 20549.

VII. Economic Analysis

The Commission recognizes that there are costs associated with the adoption of the proposed amendments to Rule 17a–5 and proposed Form Custody that are separate from the hour burdens discussed in the Paperwork Reduction Act. Thus, the Commission has identified certain costs and benefits of the proposed rule amendments and requests comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis.[195] The Commission preliminarily believes that potential costs incurred by a broker-dealer to comply with the proposed rule amendments would depend on its size and the complexity of its business activities. The size and complexity of broker-dealers vary significantly. Therefore, their costs could vary significantly. The Commission is providing estimates on the average cost per broker-dealer taking into consideration the variance in size and complexity of the business activities of broker-dealers. Any costs incurred would also vary depending on whether the broker-dealers carry customer accounts or not. For these reasons, the cost estimates represent the average cost across all broker-dealers.

The Commission seeks comment and data on the benefits identified. The Commission also seeks comment on the accuracy of its cost estimates in each section of this cost-benefit analysis, and requests those commenters to provide data, including identification of statistics relied on by commenters to reach conclusions on cost estimates. Finally, the Commission seeks estimates and views regarding these costs and benefits for particular types of market participants (*e.g.,* broker-dealers, customers of broker-dealers and independent public accountants), as well as any other costs or benefits that may result from these proposed rule amendments and the new proposed Form.

Under Section 3(f) of the Exchange Act,[196] the Commission shall, when engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[197] requires the Commission to consider the anticompetitive effects of any rules the Commission adopts under the Exchange Act. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission has considered the effects of each of the proposed amendments in this release on competition, efficiency and capital formation. The Commission's preliminary view, as discussed in greater detail with respect to each proposed amendment below, is that the proposed rule amendments may promote efficiency, competition, and capital formation and any burden on competition is justified by the benefits.

In considering the effect of the proposed amendments on capital formation, the Commission notes that broker-dealers that lack appropriate custody procedures or internal controls may expose investors to unnecessary risks. For example, if losses are incurred by investors as a result of a broker-dealer's failure to properly safeguard customer assets, investors may lose confidence in broker-dealers, which, in turn, could negatively impact the ability of companies to raise capital through securities issuances underwritten by broker-dealers. A perceived lack of such procedures should be expected to reduce investors' willingness to invest through broker-dealers, and measures, such as these proposed amendments, should thereby enhance capital formation by strengthening the operational controls of broker-dealers with respect to safeguarding customer assets. At the same time, the Commission acknowledges that additional requirements designed to safeguard investor assets could impose a burden on competition by raising compliance costs for broker-dealers.

The Commission generally requests comment on all aspects of this analysis of the burden on competition and promotion of efficiency, competition, and capital formation. Commenters should provide specific data and analysis to support their views.

A. Annual Reporting Amendments

1. Benefits

The Commission preliminarily believes that the Annual Reporting Amendments will have a number of benefits. First, the Annual Reporting Amendments would update the existing requirements of Rule 17a–5, which is

confidential, subject to the provisions of the Freedom of Information Act. 5 U.S.C. 552.

[195] For the purposes of this cost/benefit analysis, the Commission is using salary data from the Securities Industry and Financial Markets Association (''SIFMA'') Report on Management and Professional Earnings in the Securities Industry 2009, which provides base salary and bonus information for middle-management and professional positions within the securities industry. The salary costs derived from the report and referenced in this cost benefit section are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as *SIFMA's Management & Professional Earnings in the Securities Industry 2009.*

[196] 15 U.S.C. 78c(f).

[197] 15 U.S.C. 78w(a)(2).

used by the Commission to monitor the financial condition of broker-dealers. This will align the text of Rule 17a–5 with current auditing literature. Second, the amendments would facilitate PCAOB inspection and oversight authority over broker-dealer independent public accountants by providing an improved foundation for the PCAOB to establish new broker-dealer audit standards. Third, the Commission preliminarily believes that the Annual Reporting Amendments proposed in this release, if adopted, would create an efficient process for broker-dealers by enabling them to satisfy the proposed requirements under Rule 17a–5 and the IA Custody Rule's internal control report requirement.

Additionally, the Commission preliminarily believes that the proposed Annual Reporting Amendments would strengthen and improve compliance with the Financial Responsibility Rules because it would increase the focus of independent public accountants on the custody practices of broker-dealers. This could help identify broker-dealers that have weak controls for safeguarding investor assets.

The Commission preliminarily believes that the proposed Annual Reporting Amendments, by updating the existing requirements of Rule 17a–5 and requiring reports prepared by independent public accountants that make custody a greater focus of the audit, would strengthen broker-dealer compliance with the Financial Responsibility Rules and, in turn, improve the financial and operational condition of broker-dealers and the safeguarding of investor assets. These improvements could enhance investor trust in the financial markets and thereby potentially have a positive impact on capital formation.

Additionally, the Commission preliminarily believes that the proposed Annual Reporting amendments create regulatory efficiencies for broker-dealers that are also registered as investment advisers because the proposals would potentially eliminate regulatory redundancy by enabling entities subject to the IA Custody Audit Rule and the Compliance Examination to submit a single report with the Commission.

2. Costs

As discussed above, the Commission estimates that there are 305 carrying broker-dealers that would be subject to the Compliance Examination and Report based on data included in FOCUS Reports. The Commission recognizes that the proposed amendments associated with the Compliance Examination would create additional costs incurred by the broker-dealers related to their annual audits. As stated previously, the proposed requirements with respect to the Compliance Examination are based on existing requirements in Rule 17a–5. The Commission is also proposing new requirements for the Compliance Examination that are not currently in Rule 17a–5.[198]

The Commission preliminarily believes that the costs associated with the Compliance Examination would be incremental to the current annual audit costs, because the proposed amendments are based on existing requirements. Consequently, the Commission preliminarily believes that the independent public accountants would be able to build upon existing work to satisfy the new requirements. For example, as discussed above, under existing requirements, the independent public accountant, among other things, must review the accounting system, internal accounting control and procedures for safeguarding securities, including appropriate tests therefore for the period since the prior examination date.[199] The Commission preliminarily estimates that the additional costs incurred by carrying broker-dealers associated with paying their independent public accountants would average $150,000 per firm, per year. The Commission derived this cost estimate from its estimates of the costs associated with the IA Custody Rule.

The Commission estimated that the IA Custody Rule would impose costs of $250,000 per investment adviser.[200] The Commission noted that the cost to prepare an internal control report relating to custody would vary based on the size and services offered by a qualified custodian, but that the average cost for an internal control report was approximately $250,000.[201] The Commission notes that the IA Custody Rule imposed new requirements on investment advisers, and was not based on existing obligations. The Commission preliminarily believes that the costs associated with the Compliance Examination would be incremental to broker-dealers because of the existing work done by the independent public accountants. The Commission preliminarily estimates that the additional costs associated with the Compliance Examination and Examination Report to be, on average, $150,000 per year per broker-dealer. As noted above, the Commission derived this cost estimate from its estimates of the costs associated with the IA Custody Rule.

Therefore the Commission estimates an annual cost associated with this proposal to be $45,750,000 per year.[202]

The Commission estimates that 4,752 non-carrying broker-dealers would be required to file the proposed Exemption Report. As discussed above, this number is based on the number of non-carrying broker-dealers that claim exemptions from Rule 15c3–3.[203] These non-carrying broker-dealers would be required to have an independent public accountant review the claimed assertion (exemption) and prepare a corresponding report that also would be filed with the Commission. The Commission preliminarily believes that an independent public accountant's review of the exemption assertion would add an incremental cost to that incurred by the annual financial audit. As discussed above, independent public accountants engaged by broker-dealers must ''ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to [the independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination.'' [204] The Commission therefore estimates that the submission of the Exemption Report and any additional work done by the independent public accountant to conduct the review would result in an incremental increase to the current audit cost of the non-carrying broker-dealer.

The cost for paying the independent public accountant to perform a financial audit of a non-carrying broker-dealer varies depending on the size and amount of net revenues. The Commission's preliminary estimates of

[198] *See supra* discussion in Section II.B.2; the proposed Compliance Examination would result in the following four changes to existing audit work: (1) Use of PCAOB standards; (2) revised reporting requirements for the examination of the broker-dealer's assertions regarding compliance and internal controls over compliance (*i.e.,* expression of an opinion); (3) period of time of reporting on internal controls over compliance (*i.e.,* controls over compliance effective through the year instead of only at year-end); and (4) including the Account Statement Rule as part of the examination.

[199] *See* Section II.A. of this release.

[200] *See* IA Custody Adopting Release at 1478.

[201] *See* IA Custody Adopting Release at note 291 and corresponding text at 1479.

[202] $150,000 × 305 broker-dealers = $45,750,000.

[203] These numbers are based on FOCUS Report data as of year-end 2009. *See supra* notes 172–173.

[204] *See* Rule 17a–5(g)(2). As noted previously, the independent public accountants currently satisfy this requirement by including a statement in the study providing that they have ascertained that the broker-dealer was complying with the conditions of the exemption; *see Broker Dealer Audit Guide supra* note 14 at Section 3.32.

these costs as set forth below are based on staff experience, including communications with broker-dealers, broker-dealer auditors, and auditor industry groups. The Commission preliminarily estimates that the cost for an annual audit for a non-carrying broker-dealer with net revenue of less than $1 million to be $15,000. The Commission preliminarily estimates the average cost for an audit of a non-carrying broker-dealer with net revenue of $1 million to $10 million to be $20,000. The Commission preliminarily estimates the average cost of an audit of a non-carrying broker-dealer with net revenue greater than $10 million and less than $100 million to be $60,000. Finally, the Commission preliminarily estimates the average cost of an audit of a non-carrying broker-dealer with net revenue greater than $100 million to be $300,000. Therefore, the Commission preliminarily estimates the average cost for the financial audit for non-carrying broker-dealers is approximately $30,000.[205] As noted, the Commission believes that the cost of the proposed review would be incremental to costs currently incurred for the financial audit. The Commission estimates that, on average, the additional average cost would be approximately $3,000 for each non-carrying broker-dealer.[206] Therefore, the total annual cost for all non-carrying broker-dealers required to submit Exemption Reports is estimated to be $14,256,000.[207]

The Commission preliminarily believes that the proposed amendments may impose a burden on competition for smaller broker-dealers to the extent that they impose relatively fixed costs, which would represent a higher percentage of net income for smaller broker-dealers. However, the Commission preliminary believes that the incremental costs resulting from the proposed amendments would not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

B. Access to Audit Documentation Amendments

1. Benefits

The Commission preliminarily believes that the proposed Access to Audit Documentation Amendments would have a number of benefits. These proposed rules would make it easier for the Commission and DEAs to access information about a clearing broker-dealer's independent public accountant's work and the steps taken by the independent public accountant to audit the broker-dealer's financial statements. In turn, this information would enable the Commission and DEA examiners to more efficiently deploy examination resources.[208] The Commission preliminarily believes that examiners reviewing the audit documentation may tailor the scope of their examinations by identifying areas where extensive audit work was performed by the independent public accountant and focusing their examinations on other areas. Enabling Commission and DEA examination staff to conduct more focused examinations of broker-dealers could, in turn, provide investors with greater protection, as examination resources could be allocated more strategically for their benefit.

2. Costs

The Commission notes that clearing broker-dealers would incur additional costs from the proposed Access to Audit Documentation Amendments by permitting representatives of the Commission and its DEA to discuss with the independent public accountants the findings in their audit reports and to review the audit documentation associated with the audit reports. While the Commission does not anticipate that its representatives would need to discuss findings and review audit documentation with respect to each clearing broker-dealer annually, the Commission's estimate is nevertheless based on the total number of clearing broker-dealers. Further, the Commission assumes that independent public accountants would charge their clearing broker-dealer clients for any time spent with the Commission and DEA representatives discussing the findings associated with the annual audit reports and providing access to the documentation associated with the annual audit reports. The Commission estimates clearing broker-dealers would incur an additional $660,000 per year in annual costs.[209]

The Commission preliminarily believes that the proposed amendments may impose a burden on competition for smaller broker-dealers to the extent that they impose relatively fixed costs, which would represent a higher percentage of net income for smaller broker-dealers. However, the Commission preliminarily believes that the incremental costs resulting from the proposed amendments would not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, given the investor protection objectives of the proposed amendments.

C. Proposed Form Custody and Related Requirements

1. Benefits

The Commission frequently brings enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets.[210] The Commission also has brought an enforcement action against the accountant responsible for auditing one of these broker-dealers.[211] In order to enhance protection, the Commission has taken steps to enhance oversight of the custody function of investment advisers[212] and preliminarily believes that the proposal to adopt Form Custody will provide information related to custodial practices of broker-dealers that, in turn, will better protect investors who entrust funds and securities to broker-dealers. Proposed Form Custody would be filed with a broker-dealer's quarterly FOCUS Reports and would elicit information about whether and how the broker-dealer maintains custody of assets. This form would consolidate information about the broker-dealer's custodial responsibility and relationships with other custodians in one report so that the Commission and other securities regulators can have a more comprehensive understanding of the broker-dealer's custody practices and arrangements. Further, the Commission

[205] The average is derived from applying the number of broker-dealers with the given net revenue ranges and multiplying it by the estimated audit costs; for example there are over 2,000 non-carrying broker-dealers with net revenues under $1 million; however there are over 1500 firms with net revenue between $1 million and $10 million and so forth. The Commission preliminarily estimates the average audit cost to be $30,000.

[206] Based on staff experience the Commission believes that the incremental work done to conduct the review represents 10% of the current work done. Therefore the Commission estimates an average additional cost of around $3,000 (10% * $30,000).

[207] $3,000 × 4,752 = $14,256,000.

[208] As discussed previously, the Commission preliminarily believes that where an independent public accountant has performed extensive testing of a carrying broker-dealer's custody of securities and cash by confirming holdings at subcustodians, examiners could focus their efforts on matters that had not been the subject of prior testing and review.

[209] Based on industry sources, the Commission estimates that the hourly cost of an independent public accountant to be $250. With an additional 5 hours per year, the annual hour burden would be 2,640 (528 clearing broker-dealers × 5 hours) for a yearly cost estimate of $660,000 (2,640 hours × $250 per hour).

[210] *See supra* note 123.

[211] *SEC* v. *David G. Friehling, C.P.A., et al.,* Litigation Release No. 20959 (Mar. 18, 2009).

[212] *See supra* note 124.

believes that the additional information made available on the proposed form would aid in the examination of broker-dealers, because the examination staff could use the form as another tool for purposes of prioritizing and planning examinations.

The Commission believes that the proposed Form Custody amendments also could enhance investor confidence. By establishing a discipline under which broker-dealers are required to report to the Commission greater detail as to their custodial functions, investor perception as to the safety of their funds and securities at broker-dealers could improve. This, in turn, could increase the willingness of investors to provide capital for investment through broker-dealers.

2. Costs

The proposed form is comprised of nine line items that elicit information about the broker-dealer's custodial responsibilities and operations. Some of the Items contain multiple questions and also elicit information by requiring charts to be filled out or additional information to be provided in spaces provided.[213]

The cost of compliance will vary given the variation in the size and complexity of the businesses of the brokers and dealers subject to Rule 17a–5. The Commission estimates that, on average, each report would require approximately 12 hours for a broker-dealer to complete.[214] As noted above, the Commission proposes to require that firms file proposed Form Custody on a quarterly basis. Therefore, the Commission estimates that there would be 20,228 annual responses [215] and therefore a total annual hour burden of 242,736 hours.[216] Thus, the Commission anticipates that the annual cost to the industry will be $69,179,760.[217]

The Commission preliminarily believes that the proposed amendments could have a burden on competition because they could increase compliance costs for broker-dealers. However, the Commission preliminarily believes that this proposed amendment would not have a disproportionate effect on smaller broker-dealers. The Commission expects that smaller firms in completing proposed Form Custody will incur fewer associated costs because the information required to be disclosed is less. For example, broker-dealers that introduce customers on a fully disclosed basis and do not have custody of customer funds or assets would leave much of the Form blank.

C. Request for Comment on Economic Analysis

The Commission seeks estimates of the costs and benefits identified in this Economic Analysis Section, as well as any costs and benefits not already discussed, which may result from the adoption of the proposed amendments and form.

The Commission also requests comment on the potential costs and benefits of alternatives suggested by commenters. The Commission specifically requests comments with respect to the following:

- With respect to the costs estimates for the proposed Compliance Examination and corresponding Examination Report, is the cost associated with the IA Custody Rule comparable? Is the Commission's estimated cost for the proposed Compliance Examination and Examination Report conservative or too low?
- With respect to the costs estimates for the proposed Compliance Examination, do commenters believe that there could be some cost savings because some respondents would no longer have to engage an independent public accountant to perform the internal control examination required by the IA Custody Rule? If so, how much savings could be generated?
- With respect to the cost estimates for the proposed Exemption Report and review by the independent public accountant, would the amount of additional work for the review by the independent public accountant be greater than estimated by the Commission?
- Are there any additional costs associated with the proposed Access to Audit Documentation Amendments that are not currently contemplated in the Economic Analysis section? Will independent public accountants allocate the costs associated with the proposed Access to Audit Documentation Amendments to broker-dealers?
- With respect to the cost estimates for proposed Form Custody, do commenters believe that broker-dealers will need more than the estimated 12 hours to complete the form? If so, why? Also, please provide an alternative estimate.
- Are there any additional economic effects related to efficiency, capital formation or competition that the Commission has not identified?

The Commission generally requests comment on the competitive or anticompetitive effects as well as efficiency and capital formation effects, of the proposed amendments and form on any market participants if the proposals are adopted. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposed amendments and form.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,'' [218] the Commission must advise OMB whether a proposed regulation constitutes a major rule. Under SBREFA, a rule is ''major'' if it has resulted in, or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- A significant adverse effect on competition, investment, or innovation.

If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requests comment on the potential impact of the proposed rule amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

IX. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (''IRFA''), in accordance with the provisions of the Regulatory Flexibility Act,[219] regarding the proposed rule amendments to Rule 17a–5 under the Exchange Act.

A. Reasons for the Proposed Action

The proposed Annual Reporting Amendments are designed to, among other things: (1) Update the existing requirements of Rule 17a-5; (2) facilitate

[213] *See supra* Section IV for discussion of each proposed item of Form Custody.

[214] *See* supra note 190; the Commission's current hour burden associated with a broker-dealer filing a FOCUS Report is 12 hours.

[215] 5,057 firms × 4 times a year = 20,228 total responses.

[216] 20,228 total responses × 12 hours per Form Custody = 242,736.

[217] The Commission anticipates that one or more Financial Reporting Managers, at an average cost of $285 per hour, would be responsible for completion of Form Custody. This $285 per hour figure for a Financial Reporting Manager is based upon information obtained from *SIFMA's Management & Professional Earnings in the Securities Industry 2009* publication, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Thus, the annual cost burden is estimated to be $69,179,760 (242,736 total hours × $285 per hour).

[218] Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[219] 5 U.S.C. 603.

the ability of the PCAOB to implement oversight of independent public accountants of broker-dealers as required by the Dodd-Frank Act; and (3) eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers.

The Commission preliminarily believes the Access to Audit Documentation Amendments would enhance Commission and DEA examinations of broker-dealers by providing examiners with access to additional relevant information, which could improve the efficiency and effectiveness of the examination process. The Commission preliminarily believes that Commission and DEA examiners could use the Access to Audit Documentation Amendments to develop the scope for their examinations of clearing broker-dealers.

Currently, limited information is elicited about the scope of the broker-dealer's custodial function and the manner in which it handles assets of customers and other persons. The Commission, therefore, is proposing Form Custody, which it preliminarily believes would be useful because it provides information about the custodial activities of the broker-dealer that can serve as a starting point for examiners to undertake more in-depth reviews as they deem appropriate.

B. Objectives

The objectives of the proposed Form Custody Amendments are to enhance the Commission's oversight of broker-dealers, especially with respect to broker-dealers' custody of assets. As stated previously, the Commission preliminarily believes that proposed Form Custody would provide useful information that is currently not routinely made available to the Commission. In addition, the proposed Access to Audit Documentation Amendments would assist the examination of broker-dealers. Another objective of the proposed Annual Reporting Amendments is, among other things, to update the existing provisions of Rule 17a–5 to align the text of the rule with current auditing literature.

C. Legal Basis

Pursuant to the Exchange Act [220] and, particularly, Sections 15(c), 17(a), 17(E) and 23 of the Exchange Act, the Commission is proposing amendments to Rule 17a–5 and new Form Custody.[221]

D. Small Entities Subject to the Rule

Paragraph (a) of Rule 0–10 provides that for purposes of the Regulatory Flexibility Act, a small entity ''[w]hen used with reference to a broker or dealer, the Commission has defined the term ''small entity'' to mean a broker or dealer (''small broker-dealer'' that: (1) Had total capital (net worth plus subordinated liabilities of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements, were prepared pursuant to Rule 17a–5(d) or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated debt) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this release.'' [222] Currently, based on FOCUS Report data, there are 871 broker-dealers that are classified as ''small'' entities for purposes of the Regulatory Flexibility Act.[223]

E. Reporting, Recordkeeping, and Other Compliance Requirements

The Commission proposes three amendments to Rule 17a–5: The (1) Annual Reporting Amendments; (2) Access to Audit Documentation Amendments; and (3) Form Custody Amendments.

The Commission preliminarily believes that the potential impact of the proposals on small broker-dealers would be substantially less than on larger firms. With respect to the Annual Reporting Amendments, small broker-dealers would be subject to the Exemption Report, and not the proposed Compliance Report and Examination.[224] Therefore, small broker-dealers would engage their independent public accountant to review their Exemption Reports and would be subject to the additional costs associated with that review. Additionally, these firms could be required to pay additional fees to their independent public accountant, should the Commission or DEA examiners decide to interview them.

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed rule amendments.

G. Significant Alternatives

Pursuant to Section 3(a) of the Regulatory Flexibility Act,[225] the Commission must consider certain types of alternatives, including: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rule, or any part of the rule, for small entities.

The Commission considered whether it is necessary or appropriate to establish different compliance or reporting requirements or timetables; or clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities. Because the proposed rule amendments would enhance the Commission's oversight, the Commission preliminarily believes that small entities should be covered by the rule. The Commission also preliminarily believes that it would not be necessary to establish different compliance requirements for small broker-dealers, in that, as discussed previously, the proposed amendments are based in large part on existing compliance requirements in Rule 17a–5. Similarly, the Commission does not believe it would be necessary to establish different compliance requirements for small broker-dealers with respect to Form Custody. The information that would be elicited on the form is designed to allow examiners to obtain an understanding of the custody practices of all types of broker-dealers. Therefore, the Commission preliminarily believes that having inconsistent requirements could undermine the objectives of the proposed requirement.

H. Request for Comments

The Commission encourages written comments on matters discussed in this IRFA. In particular, the Commission seeks comment on the number of small entities that would be affected by the proposed rule amendments and whether the effect on small entities would be economically significant. Commenters are asked to describe the nature of any effect and to provide empirical data to support their views.

[220] 15 U.S.C. 78a *et seq.*

[221] 15 U.S.C. 78o.

[222] 17 CFR 240.0–10(c).

[223] *See* 17 CFR 240.0–10(a).

[224] There are no broker-dealers that are carrying firms that satisfy the definition of a ''small'' broker-dealer.

[225] 5 U.S.C. 603(c).

X. Statutory Authority and Text of the Proposed Amendments

The Commission is proposing amendments to Rule 17a–5 under the Exchange Act pursuant to the authority conferred by the Exchange Act, including Sections 15, 17, 23(a) and 36.[226]

List of Subjects in 17 CFR Parts 240 and 249

Brokers, Confidential business information, Fraud, Reporting and recordkeeping requirements, Securities.

Text of the Proposed Amendments

For the reasons set out in the preamble, the Commission proposes to amend Title 17, Chapter II, of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78n–1, 78o, 78o–4, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*, 18 U.S.C. 1350, and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

2. Section 240.17a–5 is amended by:

a. In paragraph (a)(2)(ii), in the first sentence, removing the phrase ''annual audit of financial statements where said date is other than a calendar quarter'' and adding in its place ''annual reports where said date is other than the end of a calendar quarter.'';

b. In paragraph (a)(2)(iii), removing the phrase ''the annual audit of financial statements where said date is other than the end of the calendar quarter.'' and adding in its place ''the annual reports where said date is other than the end of a calendar quarter.'';

c. In paragraph (a)(2)(iv), adding the phrase ''(''designated examining authority'')'' after the phrase ''section 17(d) of the Act'';

d. Redesignating paragraphs (a)(5) and (a)(6) as paragraphs (a)(6) and (a)(7);

e. In newly redesignated paragraph (a)(6)(ii)(A), removing the phrase ''(a)(5)(i)'' and adding in its place ''(a)(6)(i)'';

f. Adding new paragraph (a)(5);

g. In paragraph (b)(4), removing the word ''he'' and adding in its place the phrase ''the broker or dealer''.

h. Removing paragraph (b)(6);

i. In paragraph (c)(1)(i), removing the phrase ''his customers'' and adding in its place the phrase ''customers of the introducing broker or dealer'';

j. In paragraph (c)(1)(iii), removing the phrase ''in the manner contemplated by the $2,500 minimum net capital requirement of § 240.15c3–1'' and adding in its place ''and otherwise qualified to maintain net capital of no less than what is required pursuant to § 240.15c3–1(a)(2)(iv)'';

k. In paragraph (c)(2), in the first sentence, removing the phrase ''audited financial statements'' and adding in its place ''financial report'';

l. In paragraph (c)(2)(i) removing the phrase ''balance sheet with appropriate notes prepared in accordance with'' and adding in its place ''Statement of Financial Condition with appropriate notes prepared in accordance with U.S.'';

m. Removing paragraph (c)(2)(iii);

n. Redesignating paragraph (c)(2)(iv) as (c)(2)(iii);

o. In newly redesignated paragraph (c)(2)(iii), removing the phrase ''annual audit report'' and adding in its place ''financial report'';

p. Adding new paragraph (c)(2)(iv);

q. In paragraph (c)(4) removing the word '''customer''' and adding in its place the word ''*customer*'';

r. In paragraphs (c)(5)(ii)(A) and (c)(5)(iii), removing the phrase ''Web site'' and adding in its place ''website'';

s. In paragraph (c)(5)(vi), removing the phrase ''was not required by paragraph (e) of § 240.17a–11 to give notice and transmit a report to the Commission'' and replacing it with ''received an unqualified financial statement audit report pursuant to paragraph (g) of this section and neither the broker or dealer, pursuant to paragraph (d) of this section, or the independent public accountant, pursuant to paragraph (g) of this section, identified a material weakness or instance of material non-compliance'';

t. Revising paragraph (d);

u. In paragraph (e) introductory text, removing the phrase ''financial statements'' and adding in its place ''annual reports'';

v. Revising paragraph (e)(1);

w. In paragraph (e)(2), in the first sentence, adding the word ''financial'' before ''report'';

x. Revising paragraphs (e)(3) and (e)(4);

y. Removing paragraph (e)(5);

z. Revising paragraphs (f), (g), (h), and (i); and

aa. Removing and reserving paragraph (j).

The revisions and additions read as follows:

§ 240.17a–5 Reports to be made by certain brokers and dealers.

(a) * * *

(5) Every broker or dealer subject to this paragraph (a) shall file Form Custody (§ 249.1900 of this chapter) with its designated examining authority within 17 business days after the end of each calendar quarter and within 17 business days after the date selected for the annual reports where said date is other than the end of a calendar quarter. The designated examining authority shall maintain the information obtained through the filing of Form Custody and transmit such information to the Commission, at such time as it transmits the applicable part of Form X–17A–5 (§ 249.617 of this chapter) as required in paragraph (a)(4) of this section.

* * * * *

(c) * * *

(2) * * *

(iv) If in connection with the most recent annual report the independent public accountant provided notice to the Commission pursuant to paragraph (h) of this section, there shall be a statement by the broker or dealer that a copy of such notice is currently available for the customer's inspection at the principal office of the Commission in Washington, DC.

* * * * *

(d) *Annual reports.* (1)(i) Every broker or dealer registered pursuant to section 15 of the Act shall file annually, on a calendar or fiscal year basis:

(A) A financial report as described in paragraph (d)(2) of this section;

(B)(*1*) A compliance report as described in paragraph (d)(3) of this section unless the broker or dealer is exempt from the provisions of § 240.15c3–3; or

(*2*) An exemption report described in paragraph (d)(4) of this section if the broker or dealer is exempt from the provisions of § 240.15c3–3; and

(C) For each report filed pursuant to this paragraph (d), a report prepared by an independent public accountant pursuant to the engagement provisions set forth in paragraph (g)(1) of this section, except as provided in paragraphs (d)(1) and (e)(1) of this section.

(ii) The reports required to be filed under this paragraph (d) shall be as of the same fixed or determinable date each year, unless a change is approved in writing by the designated examining authority for the broker or dealer. A copy of such written approval should be sent to the regional office of the Commission for the region in which the broker or dealer has its principal place of business.

[226] 15 U.S.C. 78o, 78q, 78w(a) and 78mm.

(iii) A broker or dealer succeeding to and continuing the business of another broker or dealer need not file the reports under this paragraph (d) as of a date in the fiscal or calendar year in which the succession occurs if the predecessor broker or dealer has filed a report in compliance with this paragraph (d) as of a date in such fiscal or calendar year.

(iv) A broker or dealer that is a member of a national securities exchange and has transacted a business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance or security for any person who is defined as a *customer* in paragraph (c)(4) of this section, shall not be required to file the reports under this paragraph.

(2) *Financial report.* The financial report shall contain:

(i) A Statement of Financial Condition (in a format and on a basis that is consistent with the total reported on the Statement of Financial Condition contained in Form X–17A–5 (§ 249.617 of this chapter) Part II or IIA), a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors. Such statements shall be in a format that is consistent with such statements as contained in Form X–17A–5 Part II or Part IIA. If the Statement of Financial Condition filed in accordance with instructions to Form X–17A–5, Part II or Part IIA, is not consolidated, a summary of financial data, including the assets, liabilities, and net worth or stockholders' equity, for subsidiaries not consolidated in the Part II or Part IIA Statement of Financial Condition as filed by the broker or dealer should be included in the notes to the consolidated statement of financial condition reported on by the independent public accountant.

(ii) Supporting schedules shall include, from Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter) a Computation of Net Capital Under § 240.15c3–1, a Computation for Determination of the Reserve Requirements under Exhibit A of § 240.15c3–3 and Information Relating to the Possession or Control Requirements Under § 240.15c3–3 and shall be filed with said report.

(iii) If either the Computation of Net Capital under § 240.15c3–1 or the Computation for Determination of the Reserve Requirements Under Exhibit A of § 240.15c3–3 in the financial report is materially different from the corresponding computation in the most recent Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter) filed by the broker or dealer pursuant to paragraph (a) of this section, then the broker or dealer shall include in the financial report a reconciliation, including appropriate explanations, between the computation in the financial report and the computation in the most recent Part II or Part IIA of Form X–17A–5 filed by the broker or dealer. If no material differences exist, a statement so indicating shall be included in the financial report.

(3) *Compliance report.* (i) The compliance report shall contain:

(A) A statement as to whether the broker or dealer has established and maintained a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, and any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (''Account Statement Rule'') will be prevented or detected on a timely basis;

(B) Assertions by the broker or dealer that include:

(*1*) Whether it was in compliance in all material respects with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, and the Account Statement Rule as of the fiscal year-end;

(*2*) Whether the information used to assert compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, and the Account Statement Rule was derived from the books and records of the broker or dealer; and

(*3*) Whether the internal control over compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, and the Account Statement Rule was effective during the most recent fiscal year such that there were no instances of material weakness; and

(C) A description of each identified instance of material non-compliance and each identified material weakness in internal control over compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, and the Account Statement Rule.

(ii) The broker or dealer is not permitted to conclude that it is in compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13 and the Account Statement Rule if it identifies one or more instances of material non-compliance. For purposes of this paragraph material non-compliance would be a failure by the broker or dealer to comply with the requirements of §§ 240.15c3–1, 240.15c3–3, and 240.17a–13 or the Account Statement Rule in all material respects.

(iii) The broker or dealer is not permitted to conclude that the internal control over compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, and the Account Statement Rule were effective if there were one or more instances of material weakness in the internal control over compliance. For purposes of this paragraph, an instance of material weakness is defined as a deficiency, or a combination of deficiencies, in internal control over compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, and the Account Statement Rule, such that there is a reasonable possibility that material non-compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, or the Account Statement Rule will not be prevented or detected on a timely basis. For purposes of this paragraph a deficiency in internal control over compliance exists when the design or operation of a control does not allow the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect non-compliance with §§ 240.15c3–1, 240.15c3–3, and 240.17a–13, or the Account Statement Rule on a timely basis.

(4) *Exemption report.* The exemption report shall contain an assertion by the broker or dealer that it is exempt from the provisions of § 240.15c3–3 because it meets conditions set forth in § 240.15c3–3(k) and should identify the specific conditions.

(5) The annual reports shall be filed not more than sixty (60) days after the date of the financial statements.

(6) The annual reports shall be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, and the principal office of the designated examining authority for said broker or dealer and with the Securities Investor Protection Corporation. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement.

(e) * * *

(1)(i) The broker or dealer need not engage an independent public accountant to provide the reports required pursuant to paragraph (d) of this section if, since the date of the registration of the broker or dealer pursuant to Section 15 of the Act (15 U.S.C. 78o) or of the previous annual reports filed pursuant to paragraph (d) of this section:

(A) The securities business of such broker or dealer has been limited to acting as broker (agent) for the issuer in soliciting subscriptions for securities of such issuer, said broker has promptly transmitted to such issuer all funds and promptly delivered to the subscriber all securities received in connection therewith, and said broker has not otherwise held funds or securities for or owed money or securities to customers; or

(B) Its securities business has been limited to buying and selling evidences of indebtedness secured by mortgage, deed or trust, or other lien upon real estate or leasehold interests, and said broker or dealer has not carried any margin account, credit balance or security for any securities customer.

* * * * *

(3) The annual reports filed pursuant to paragraph (d) of this section shall be public, except that, if the Statement of Financial Condition in a format that is consistent with Form X–17A–5 (§ 249.617 of this chapter), Part II or Part IIA, is bound separately from the balance of the annual report filed pursuant to paragraph (d)(2) of this section, and each page of the balance of the annual report is stamped confidential, then the balance of the annual report shall be deemed confidential. However, the annual reports, including the confidential portions, shall be available for official use by any official or employee of the U.S. or any State, by national securities exchanges and registered national securities associations of which the person filing such a report is a member, by the PCAOB and by any other person to whom the Commission authorizes disclosure of such information as being in the public interest. Nothing contained in this paragraph shall be deemed to be in derogation of the rules of any registered national securities association or national securities exchange that give to customers of a member broker or dealer the right, upon request to such member broker or dealer, to obtain information relative to its financial condition.

(4)(i) The broker or dealer shall file with the Securities Investor Protection Corporation (''SIPC'') a report on the SIPC annual general assessment reconciliation or exclusion from membership forms that contains such information and is in such format as determined by SIPC by rule and approved by the Commission.

(ii) Until the earlier of two years after the date paragraph (e)(4)(i) of this section is effective or SIPC adopts a rule pursuant to paragraph (e)(4)(i) of this section and the rule is approved by the Commission, the broker or dealer shall file a supplemental report on the status of the membership of the broker or dealer in SIPC if, pursuant to paragraph (d)(1)(i)(C) of this section, the broker or dealer is required to file reports prepared by an independent public accountant. The supplemental report shall include the independent public accountant's report on applying agreed-upon procedures based on the performance of the procedures outlined in paragraph (e)(4)(ii)(C). The supplemental report shall cover the SIPC annual general assessment reconciliation or exclusion from membership forms not previously reported on under this paragraph (e)(4) that were required to be filed on or prior to the date of the reports required by paragraph (d) of this section: Provided, that the broker or dealer need not file the supplemental report on the SIPC annual general assessment reconciliation or exclusion from membership form for any period during which the SIPC assessment is a specified dollar value as provided for in section 4(d)(1)(c) of the Securities Investor Protection Act of 1970, as amended. The supplemental report shall be filed with the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and the principal office of SIPC. The supplemental report shall include the following:

(A) A schedule of assessment payments showing any overpayments applied and overpayments carried forward including: Payment dates, amounts, and name of SIPC collection agent to whom mailed, or

(B) If exclusion from membership was claimed, a statement that the broker or dealer qualified for exclusion from membership under the Securities Investor Protection Act of 1970, and

(C) *An accountant's report.* The accountant shall be engaged to perform the following procedures:

(*1*) Comparison of listed assessment payments with respective cash disbursements record entries;

(*2*) For all or any portion of a fiscal year ending, comparison of amounts reflected in the annual report as required by paragraph (d) of this section, with amounts reported in the Annual General Assessment Reconciliation (Form SIPC–7);

(*3*) Comparison of adjustments reported in Form SIPC–7 with supporting schedules and working papers supporting adjustments;

(*4*) Proof of the arithmetical accuracy of the calculations reflected in Form SIPC–7 and in the schedules and working papers supporting adjustments; and

(*5*) Comparison of the amount of any overpayment applied with the Form SIPC–7 on which it was computed; or

(*6*) If exclusion from membership is claimed, a comparison of the income or loss reported in the financial report required by paragraph (d) of this section to the Certification of Exclusion from Membership (Form SIPC–3).

(f)(1) *Qualification of accountants.* The independent public accountant must be qualified and independent in accordance with § 210.2–01 of this chapter and, in addition, the independent public accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.

(2) *Designation of accountant.* (i) Every broker or dealer that is required by paragraph (d) of this section to file annual reports shall file no later than December 10 of each year (or 30 calendar days after the effective date of its registration as a broker or dealer, if earlier) a statement as prescribed in paragraph (f)(2)(ii) of this section designating an independent public accountant with the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer. The statement must be dated no later than December 1. If the engagement of the independent public accountant is of a continuing nature, providing for successive engagements, no further filing is required. If the engagement is for a single year, or if the most recent engagement has been terminated or amended, a new statement must be filed by the required date.

(ii) The statement must be headed ''Notice pursuant to Rule 17a–5(f)(2)'' and must contain the following information and representations:

(A) Name, address, telephone number, and registration number of the broker or dealer;

(B) Name, address, and telephone number of the independent public accountant;

(C) The date of the annual reports of the broker or dealer covered by the engagement;

(D) Whether the engagement is for a single year or is of a continuing nature;

(E) A representation that the engagement of the independent public

accountant by the broker or dealer meets the required undertakings of paragraph (g) of this section; and

(F) A representation that the broker or dealer agrees to allow representatives of the Commission or its designating examining authority, if requested for purposes of an examination of the broker or dealer, to review the documentation associated with the reports of the independent public accountant prepared pursuant to paragraph (g) of this section.

(G) A representation that the broker or dealer agrees to permit the independent public accountant to discuss with representatives of the Commission and its designated examining authority, if requested for purposes of an examination of the broker or dealer, the findings associated with the reports of the independent public accountant prepared pursuant to paragraph (g) of this section.

(iii) A broker or dealer that does not carry nor clear transactions nor carry customer accounts is not required to include the representations in paragraphs (e)(2)(ii)(F) and (e)(2)(ii)(G) of this section.

(iv) Any broker or dealer that is exempted from the requirement to file an annual audited report of financial statements shall nevertheless file the notice specified herein indicating the date as of which the unaudited report will be prepared.

(v) Notwithstanding the date of filing specified in paragraph (f)(2)(i) of this section, every broker or dealer shall file the notice provided for in paragraph (f)(2) of this section within 30 days following the effective date of registration as a broker or dealer.

(3) *Replacement of accountant.* A broker or dealer must file a notice that must be received by the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for such broker or dealer, not more than 15 business days after:

(i) The broker or dealer has notified the independent public accountant whose reports covered the most recent annual reports filed under paragraph (d) of this section that the independent public accountant's services will not be utilized in future engagements; or

(ii) The broker or dealer has notified an independent public accountant who was engaged to provide reports covering the annual reports to be filed under paragraph (d) of this section that the engagement has been terminated; or

(iii) An independent public accountant has notified the broker or dealer that the independent public accountant would not continue under an engagement to provide reports covering the annual reports to be filed under paragraph (d) of this section; or

(iv) A new independent public accountant has been engaged to provide reports covering the annual reports to be filed under paragraph (d) of this section without any notice of termination having been given to or by the previously engaged independent public accountant.

(v) Such notice must provide:

(A) The date of notification of the termination of the engagement or of the engagement of the new independent public accountant as applicable; and

(B) The details of any issues arising during the 24 months (or the period of the engagement, if less) preceding such termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable rules of the Commission, which issues, if not resolved to the satisfaction of the former independent public accountant, would have caused the independent public accountant to make reference to them in the report of the independent public accountant. The issues required to be reported include both those resolved to the former independent public accountant's satisfaction and those not resolved to the former accountant's satisfaction. Issues contemplated by this section are those that occur at the decisionmaking level—i.e., between principal financial officers of the broker or dealer and personnel of the accounting firm responsible for rendering its report. The notice must also state whether the accountant's report covering the annual reports filed under paragraph (d) of this section for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and must describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The broker or dealer must also request the former independent public accountant to furnish the broker or dealer with a letter addressed to the Commission stating whether the independent public accountant agrees with the statements contained in the notice of the broker or dealer and, if not, stating the respects in which independent public accountant does not agree. The broker or dealer must file three copies of the notice and the accountant's letter, one copy of which must be manually signed by the sole proprietor, or a general partner or a duly authorized corporate officer, as appropriate, and by the independent public accountant, respectively.

(g) *Engagement of independent public accountant.* Every broker or dealer required to file the annual reports pursuant to paragraph (d) of this section shall engage an independent public accountant, unless the broker or dealer is subject to the exclusions in paragraphs (d)(1) and (e)(1)(i) of this section. The independent public accountant as part of the engagement must undertake the following, as applicable:

(1) To prepare an independent public accountant's report based on an examination of the financial report required to be filed by the broker or dealer under paragraph (d)(2) of this section in accordance with standards of the Public Company Accounting Oversight Board; and

(2)(i) To prepare an independent public accountant's report based on an examination of the compliance report required to be filed by the broker or dealer under paragraph (d)(3) of this section in accordance with standards of the Public Company Accounting Oversight Board. This examination and the related report would apply to the assertions of the broker or dealer required under paragraph (d)(3) of this section; or

(ii) To prepare an independent public accountant's report based on a review of the exemption report required to be filed by the broker or dealer under paragraph (d)(4) of this section in accordance with standards of the Public Company Accounting Oversight Board.

(h) *Notification of material non-compliance.* Upon determining any material non-compliance exists during the course of preparing the independent public accountant's reports, the independent public accountant must notify the Commission within one business day of the determination by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations and provide a copy of such notification in the same manner to the principal office of the designated examining authority for the broker or dealer within one business day of the finding.

(i) *Reports prepared by the independent public accountant.*

(1) *Technical requirements.* The independent public accountant's reports shall:

(i) Be dated;

(ii) Be signed manually;

(iii) Indicate the city and state where issued; and

(iv) Identify without detailed enumeration the items covered by the reports.

(2) *Representations as to the examinations and review.* The accountant's report shall:

(i) State whether the examination or review was made in accordance with standards of the Public Company Accounting Oversight Board;

(ii) Designate any examination and, if applicable, review procedures deemed necessary by the independent public accountant under the circumstances of the particular case that have been omitted, and the reason for their omission.

(iii) Nothing in this section shall be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the opinions or statement required under this section.

(3) *Opinion to be expressed.* The independent public accountant's reports shall state clearly the opinion of the independent public accountant:

(i) With respect to the financial report and the accounting principles and practices reflected therein and the compliance report; and

(ii) With respect to the financial report, as to the consistency of the application of the accounting principles, or as to any changes in such principles that have a material effect on the financial statements.

(4) *Exceptions.* Any matters to which the independent public accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports.

3. Section 240.17a–11 is amended by revising paragraph (e) introductory text to read as follows:

§ 240.17a–11 Notification provision for brokers and dealers.

* * * * *

(e) Whenever any broker or dealer discovers, or is notified by an independent public accountant pursuant to § 240.17a-12(i)(2), of the existence of any material inadequacy as defined in § 240.17a-12(h)(2), the broker or dealer shall:

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

4. The authority citation for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a *et seq.* and 7201 *et seq.;* and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Note: The text of Form Custody does not, and this amendment will not, appear in the Code of Federal Regulations.

5. Add Subpart T and Form Custody (referenced in § 249.1900) to Part 249 to read as follows:

Subpart T—Form for Broker-Dealers

§ 249.1900 Form Custody

BILLING CODE 8011–01–P

This form shall be used for reports of information required by § 240.17a-5 of this chapter.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM CUSTODY
For Broker-Dealers

(Please read instructions before preparing Form.)

Name of Broker/Dealer As of (Month/Day/Year)

_8-_____
SEC File No. CRD No.

Address of Principal Place of Business

(No. and Street) (City) (State) (Zip Code)

INSTRUCTIONS

GENERAL INSTRUCTIONS

A. Definitions: for purposes of this Form:

1. "Affiliate" means any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. Ownership of 25% or more of the common stock of an entity is deemed prima facie evidence of control.

2. "Bank" has the same meaning as in 15 U.S.C. 78c(a)(6).

3. "Broker" has the same meaning as in 15 U.S.C. 78c(a)(4).

4. "Dealer" has the same meaning as in 15 U.S.C. 78c(a)(5).

5. "Carrying broker-dealer" means a broker-dealer that holds customer accounts.

6. "Clearing broker-dealer" means a broker-dealer that clears transactions for itself or accounts of other broker-dealers either on a fully disclosed or omnibus basis.

7. "Customer" has the same meaning as in 17 CFR 240.15c3-3(a)(1).

8. "Free credit balance" means any liabilities of a broker-dealer to customers and non customers that are subject to immediate cash payment to customers and non-customers on demand, whether resulting from sales of securities, dividends, interest, deposits, or otherwise, excluding, however, funds in commodity accounts that are segregated in accordance with the Commodity Exchange Act or in a similar manner.

9. "Money Market Fund" means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 that is considered a money market fund under Investment Company Act Rule 2a-7.

10. "Omnibus account" means an account carried and cleared by another broker-dealer and containing accounts of undisclosed customers on a commingled basis that are carried individually on the books of the broker-dealer introducing the accounts.

11. "Structured debt" means any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. Structured debt is a broad category of financial instrument and includes, but is not limited to, asset-backed securities such as residential mortgage-backed securities ("RMBS") and other types of structured debt instruments such as collateralized debt obligations ("CDOs"), including synthetic and hybrid CDOs, or collateralized loan obligations ("CLOs").

INSTRUCTIONS FOR SPECIFIC LINE ITEMS

Item 1.A Answer the question by checking the appropriate box. A broker-dealer must check "Yes" if it introduces any customer accounts to another broker-dealer on a fully disclosed basis. A broker-dealer that carries customer accounts and/or introduces customer accounts on an omnibus basis must check "Yes" if it also introduces one or more customer accounts to another broker-dealer on a fully disclosed basis.

Item 1.B Item 1.B applies to broker-dealers that introduce customer accounts on a fully disclosed basis to one or more other broker-dealers. If Item 1.B applies, identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis.

Item 2.A Answer the question by checking the appropriate box. A broker-dealer must check "Yes" if it introduces any customer accounts to another broker-dealer on an omnibus basis. A broker-dealer that carries customer accounts (other than those introduced on an omnibus basis) and/or introduces customer accounts on a fully disclosed basis must check "Yes" if it also introduces one or more customer accounts to another broker-dealer on an omnibus basis.

Item 2.B Item 2.B applies to broker-dealers that introduce accounts on an omnibus basis to one or more other broker-dealers. If Item 2.B applies, identify each broker-dealer to which customer accounts are introduced on an omnibus basis.

Item 3.A Answer the question by checking the appropriate box. A broker-dealer that introduces customer accounts to another broker-dealer on an omnibus basis is a carrying broker-dealer with respect to those accounts under the Commission's broker-dealer financial responsibility rules. If those accounts are the only accounts carried by the broker-dealer, check "No" in Item 3.A, as those accounts are addressed in Items 2.A and 2.B.

Item 3.B Answer the question by checking the appropriate box. Answer "Yes" if accounts are carried by the broker-dealer for persons that are not "customers" as that term is defined in Rule 15c3-3 under the Securities Exchange Act of 1934. Examples of persons that are not customers of a broker-dealer include general partners, directors, or principal officers – such as the president, executive vice presidents, treasurer, secretary or any person performing similar functions – of the broker-dealer and accountholders that are themselves broker-dealers (unless such broker-dealer accountholders are required to be treated as customers under Rule 15c3-3).

Item 3.C Identify the types of locations where the broker-dealer holds securities. Only identify types of locations where the broker-dealer holds securities directly in the name of the broker-dealer (*i.e.*, do not identify a type of location if the broker-dealer only holds securities at the location through an intermediary). The information required by Items 3.C.i-iii is intended to identify all locations used by the broker-dealer to hold securities listed on the broker-dealer's stock record, and to elicit information concerning the frequency with which the broker-dealer performs reconciliations between the information on its stock record and information about the securities provided by the location. In Item 3.C.i, check all applicable boxes, and in Items 3.C.i-iii provide all applicable information as specified for each Item.

Item 3.D	Answer the questions in Items 3.D.i-iii by checking appropriate boxes and entering appropriate financial information, where applicable, and by providing explanations as requested. In Item 3.D.i, check "Other" if a type of security carried by the broker-dealer for customers is not listed on the chart, and for each category of security, indicate by checking the approximate box the approximate U.S. dollar market value of the securities.
Item 3.E	Answer the questions in Items 3.E.i-iii by checking appropriate boxes and entering appropriate financial information, where applicable, and providing explanations as requested. In Item 3.E.i, check "Other" if a type of security carried by the broker-dealer for persons that are not customers is not listed on the chart, and for each category of security, indicate by checking the appropriate box the approximate U.S. dollar market value of the securities.
Item 4	Answer the questions in Items 4.A.i-iii and 4.B.i-iii by checking appropriate boxes and, if applicable, providing requested information.
Item 5	Answer the questions in Items 5.A. and 5.B. by checking the appropriate box and, if applicable, providing requested information.
Item 6	Answer the questions by checking the appropriate boxes and, if applicable, providing requested information.
Item 7	Answer the question by checking the appropriate box.
Item 8	Answer the questions in Item 8 by checking appropriate boxes and, if applicable, providing requested information.
Item 9	Answer the questions in Item 9 by checking appropriate boxes and, if applicable, providing requested information.

Item 1. **A**. Does the broker-dealer introduce customer accounts on a fully disclosed basis to another broker-dealer? Yes ☐ No ☐

B. If the answer to question 1.A is "yes," identify below the broker-dealer(s) (by name and SEC No. and CRD No.) to which the customer accounts are introduced on a fully disclosed basis:

_____

_____

_____

Item 2. **A.** Does the broker-dealer introduce customer accounts to another broker-dealer on an omnibus basis? Yes ☐ No ☐

B. If the answer to question 2.A is "yes," identify below the broker-dealer(s) (by name and SEC No. and CRD No.) to which the accounts are introduced on an omnibus basis:

_____

_____

_____

Item 3. **A.** Does the broker-dealer carry securities accounts (*i.e.*, accounts that are not introduced on a fully disclosed basis to another broker-dealer) for customers?
Yes ☐ No ☐

B. Does the broker-dealer carry securities accounts (*i.e.*, accounts that are not introduced on a fully disclosed basis to any other broker-dealer) for non-customers? Yes ☐ No ☐

C. Location of Securities

i. Indicate in the chart below the types of U.S. locations used by the broker-dealer to hold securities that it carries by checking each box in the first column that applies. For each type of location selected, indicate in the third column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by the location:

	Location	**Reconciliation Frequency**
☐	**The broker-dealer's vault**	
☐	**U.S. broker-dealer(s)**	
☐	**The Depository Trust Company**	
☐	**The Options Clearing Corporation**	
☐	**U.S. bank(s)**	
☐	**Transfer Agents of Mutual fund(s) under the Investment Company Act**	

ii. Indicate in the chart below the types of U.S. locations not identified in Item 3.C.i used by the broker-dealer to hold securities that it carries by describing the type of entity in the first column. For each type of location, indicate in the second column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by location:

Other Types of U.S. Locations	**Reconciliation Frequency**

iii. Indicate in the chart below the types of foreign locations used by the broker-dealer to hold securities that it carries by describing the type of location in the first column. For each type of location indicate in the second column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by the location:

Non-U.S. Locations	Reconciliation Frequency

D. Securities and Cash Carried for the Accounts of Customers

i. Indicate by checking the appropriate boxes on the chart below the types of securities and provide the approximate U.S. dollar market value of such securities carried by the broker-dealer for the accounts of customers:

	Type of Securities	Up to $50 million	Greater than $50 million up to $100 million	Greater than $100 million up to $500 million	Greater than $500 million up to $1 billion	Greater than $1 billion up to $5 billion	Greater than $5 billion
☐	U.S. Equity Securities						
☐	Foreign Equity Securities						
☐	U.S. Listed Options						
☐	Foreign Listed Options						
☐	Domestic Corporate Debt						
☐	Foreign Corporate Debt						
☐	U.S. Public Finance Debt						
☐	Foreign Public Finance Debt						
☐	U.S. Government Debt						
☐	Foreign Sovereign Debt						
☐	U.S. Structured Debt						
☐	Foreign Structured Debt						
☐	Other						

ii. Has the broker-dealer recorded all securities it carries for the accounts of customers on its stock record? Yes ☐ No ☐

If the answer is "no," explain in the space provided why the broker-dealer has not recorded such securities on its stock record and provide the approximate U.S. dollar market value of such unrecorded securities:

_____

_____

_____

iii. Indicate in the chart below each process used by the broker-dealer with respect to free credit balances in accounts it carries for customers by checking all the boxes that apply and providing applicable information:

	Process
☐	Included in a computation under Rule 15c3-3(e)
☐	Held in a bank account under Rule 15c3-3(k)(2)(i)
☐	Swept to a U.S. bank
☐	Swept to a U.S. money market fund
☐	Other (Briefly describe in the space provided below)

E. Securities and Cash Carried for the Accounts of Non-customers

i. Indicate by checking the appropriate boxes on the chart below the types of securities and provide the approximate U.S. dollar market value of such securities carried by the broker-dealer for the accounts of non-customers:

	Type of Securities	Up to $50 million	Greater than $50 million up to $100 million	Greater than $100 million up to $500 million	Greater than $500 million up to $1 billion	Greater than $1 billion up to $5 billion	Greater than $5 billion
☐	**U.S. Equity Securities**						
☐	**Foreign Equity Securities**						
☐	**U.S. Listed Options**						
☐	**Foreign Listed Options**						
☐	**Domestic Corporate Debt**						
☐	**Foreign Corporate Debt**						
☐	**U.S. Public Finance Debt**						
☐	**Foreign Public Finance Debt**						
☐	**U.S. Government Debt**						
☐	**Foreign Sovereign Debt**						
☐	**U.S. Structured Debt**						
☐	**Foreign Structured Debt**						
☐	**Other**						

ii. Has the broker-dealer recorded all securities it carries for the accounts of non-customers on its stock record? Yes ☐ No ☐

If the answer is "no," explain in the space provided why the broker-dealer has not recorded such securities on its stock record and provide the approximate total U.S. dollar market value of such unrecorded securities:

iii. Indicate in the chart below each process used by the broker-dealer with respect to free credit balances in the securities accounts of non-customers by checking all the boxes that apply and providing applicable information:

	Process
☐	Included in a reserve computation
☐	Swept to a U.S. bank
☐	Swept to a U.S. money market fund
☐	Other (Briefly describe in space provided below) _____ _____ _____ _____ _____ _____ _____

Item 4. Acting as a Carrying Broker-Dealer for Other Broker-Dealers

A. On a fully disclosed basis

i. Does the broker-dealer carry customer accounts for another broker-dealer(s) on a fully disclosed basis? Yes ☐ No ☐

ii. If the answer to question 4.A.i is "yes," indicate the number of broker-dealers: _____

iii. If the answer to question 4.A is "yes," identify any of these broker-dealers that are affiliates of the broker-dealer by name and "SEC File No.":

_____
_____
_____

B. On an omnibus basis

i. Does the broker-dealer carry customer accounts for another broker-dealer(s) on an omnibus basis? Yes ☐ No ☐

ii. If the answer to question 4.B.i is "yes," indicate the number of broker-dealers: _____

iii. If the answer to question 4.B.i is "yes," identify any of these broker-dealers that are affiliates of the broker-dealer by name and "SEC File No.":

_____
_____
_____

Item 5. A. Does the broker-dealer send trade confirmations directly to customers and other accountholders? Yes ☐ No ☐

B. If the answer to question 5.A is "no," who sends the trade confirmations to customers and other accountholders? :_____

Item 6. A. Does the broker-dealer send account statements directly to customers and other accountholders? Yes ☐ No ☐

B. If the answer to question 6.A is "no," who sends the account statements to customers and other accountholders? :_____

C. Does the broker-dealer send account statements to anyone other than the beneficial owner of the account? Yes ☐ No ☐

Item 7. Does the broker-dealer provide customers and other accountholders with electronic access to information about the securities and cash positions in their accounts? Yes ☐ No ☐

Item 8. A. Is the broker-dealer also registered as an investment adviser:

i. With the SEC under the Investment Advisers Act of 1940? Yes ☐ No ☐

ii. With one or more U.S. states under the laws of the state? Yes ☐ No ☐

If the answer to question 8.A.i or 8.A.ii is "yes," answer each of the following items:

B. Provide the number of investment adviser clients:_____

C. Complete the following chart concerning the custodians if any (including, if applicable, the broker-dealer):

Column 1: The name of the custodian
Column 2: The identity of the custodian by SEC File No. or CRD No.
Column 3: Whether the broker-dealer/investment adviser has the authority to effect transactions in these advisory client accounts at the custodian
Column 4: Whether the broker-dealer/investment adviser has the authority to withdraw funds and securities out of any accounts at the custodian
Column 5: Whether the custodian sends account statements directly to the investment adviser clients
Column 6: Whether the investment adviser client assets are recorded on the broker-dealer's stock record

1	2	3	4	5	6
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐	Yes ☐	Yes ☐	Yes ☐

		No ☐	No ☐	No ☐	No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐

Item 9. A. Is the broker-dealer an affiliate of an investment adviser? Yes ☐ No ☐

B.i. If the answer to Item 9.A. is "yes," does the broker-dealer have custody of client assets of the adviser? Yes ☐ No ☐

B.ii. If the answer to Item 9.B.i is "yes" indicate the approximate U.S. dollar market value of the adviser client assets of which the broker-dealer has custody: ___

By the Commission.

Dated: June 15, 2011.

Elizabeth M. Murphy,

Secretary.

[FR Doc. 2011–15341 Filed 6–24–11; 8:45 am]

BILLING CODE 8011–01–C